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2022 Annual Spring Meeting

Reconsidering Value Allocation: Tools for Junior Stakeholders

Hosted by the Unsecured Trade Creditors
& Young and New Members Committees

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Value Allocation under the Bankruptcy Code

Bankruptcy Code statutes on secured creditors' rights attempt to strike a balance between the debtor's ability to retain and use property that is essential for reorganization or infuses value into the estate, while ensuring that the debtor uses the bankruptcy remedy as a shield, rather than a sword to enrich itself at the expense of secured creditors. See 7 Collier on Bankruptcy P 1111.03 (16th 2022).

Value allocation statutes

- § 506(a): secured creditor's claim is the extent of its interest in the estate's interest in property. Value is determined in light of the purpose.
- Adequate protection: a condition to (i) maintain the automatic stay, (ii) use, sell, or lease property, and (iii) provide postpetition secured interests in prepetition secured creditor's collateral (priming).
- § 362(k): secured creditor may credit bid on its collateral.
- § 1111(b)(2): converts the secured creditor's entire claim, including its deficiency, into a secured claim.
- § 1129(b)(2)(A): permits confirmation over secured creditor's objection provided the secured creditor's liens are preserved, is afforded the right to credit bid in a plan sale, or receives indubitable equivalent.

Purpose

- Provides flexibility in determining valuation time and method in light of the proposed use or disposition of the secured creditor's collateral.
- A balance between the debtor's ability to use a secured creditor's collateral and protecting the secured creditor in light of inability to enforce remedies. Protects against market decline during the bankruptcy.
- Protects against the risk that collateral is sold at an artificially low price.
- A secured creditor's lien is not stripped down to an artificially low valuation, especially when collateral value is expected to rise over time.
- Permits the debtor to retain collateral needed for reorganization or extract its value, provided the secured creditor is afforded bargained-for protections.



Tools for Reallocating Value

- A. Section 552(b)
- B. Section 506(c)
- C. Non-statutory tools
 1. *Lender Liability claims*
 2. *Rights Offerings*



Tools for Reallocating Value: § 552(b)

General Rule: Commencement of bankruptcy case cuts off a creditor's rights under any after-acquired property clause in a prepetition security agreement with debtor. 11 U.S.C. § 552(a). **Exception:** Secured creditor's prepetition lien continues in postpetition proceeds of, or postpetition rents relating to, prepetition collateral, subject to court approval "based on the equities of the case."

Equities of the Case Exception

- **Exception to the Exception:** Courts may limit, alter, or terminate the extension of a secured creditor's prepetition lien to postpetition property of the estate.
- **Factors Courts Consider to Apply the Exception to the Exception:** (i) the amount of time and estate funds expended on the collateral; (ii) the relative position of the secured party following the expenditure of estate time and money (i.e., whether the collateral has been enhanced); and (iii) the rehabilitative nature of the bankruptcy case.
- If payments are not at the expense of the estate, courts may not find that the equities of the case supports an award to the unsecured creditors. See *In re Laurel Hill Paper Co.*, 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008).
- In other cases, such as the *In re Residential Capital* case, courts have relied on § 552(b)(1) to terminate the secured creditor's lien in postpetition goodwill when "time, effort, and expense by the Debtors' estates" enhanced the value of the assets sold. *Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (In re Residential Capital, LLC)*, 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

§ 552(b) Waivers

- **DIP Financing and Cash Collateral:** Section 552(b) claims are infrequently litigated because the trustee's right to assert such claims are commonly waived (or the trustee and secured creditor stipulate that no equities exist) in connection with DIP financing facilities or cash collateral agreements, which is subject to court approval but generally approved.
- **Potential Issues:**
 - Defining the scope of the secured creditor's prepetition collateral package
 - Should/can value of pre- and postpetition collateral, such as goodwill, be bifurcated?
 - To what extent can liens attach to "proceeds" of secured creditors' collateral?
 - E.g., Liens may attach to economic value of FCC licenses but not licenses themselves. See *Spring Nextel Corp., et al. v. U.S. Bank, N.A., et al. (In re TerreStar Networks, Inc.)*, 457 B.R. 254 (2011); cf. *In re Tracy Broadcasting Corp.*, 438 B.R. 323 (Bankr. D. Colo. 2010) (10th Cir.)
 - Application of state law to define "proceeds" restricts resources available to support reorganization – is this appropriate?
 - Is the trustee's waiver of section 552(b) claims or stipulation that no equities exist to invoke 552(b) exceptions appropriate?



Tools for Reallocating Value: § 506(c)

Surcharging collateral: Section 506(c) allows debtors to "surcharge" a secured creditor's collateral for any benefit the secured creditor received by reason of the debtor's preservation or disposition of such collateral.

Purpose and Application

- **Protect the Estate:** allows trustee to request payment for money expended on, or resources committed to, preserving (and maximizing) the value of a secured creditor's collateral, provided that the expenditures are "reasonable" and "necessary."
- **Protects the Collateral:** incentivizes trustee to preserve secured creditor's collateral.
- **Scope of Expenses Covered:** typically a fact-intensive inquiry but the following are usually allowed: (i) costs directly related to maintenance and preservation of collateral, and (ii) costs associated with operating business if expenditures benefit the secured creditor, but administrative claims (requested by the trustee, not the claimants themselves), including attorney's fees and expenses, are subject to scrutiny and only allowed in limited circumstances. (E.g., in the Third Circuit, administrative expenses "may be charged only against the surplus of the debtor's estate.")
- **Carve-outs:** not addressed statutorily but generally is an agreement between a secured creditor and the trustee providing that a portion of the secured creditor's collateral may be used to pay administrative expenses; carve-outs are common in DIP financing facilities and subject to court approval.

§ 506(c) Waivers

- **DIP Financing and Cash Collateral:** Section 506(c) claims are infrequently litigated because the trustee's right to assert such claims are commonly waived in connection with DIP financing facilities or cash collateral agreements, forcing the trustee to rely on negotiated carve-outs or other consensual agreements to fund claims in connection with the sale of collateral, each subject to court approval.
- **Potential Issues:**
 - Are negotiated carve-outs sufficient to counterbalance the impact of 506(c) waivers?
 - What is the impact of 506(c) waivers on other stakeholders who are beneficiaries of the estate?
 - 506(c) waivers typically mean that courts do not have the opportunity to consider the appropriate allocation of expenses between the estate and the secured creditor – is this appropriate?



Tools for Reallocating Value: Lender Liability

"Lender liability" is a generic umbrella term covering various legal theories by which a lender may be found liable to a borrower under their loan arrangement.

Traditional Claims

- **Breach of contract examples:** failure to (i) honor loan commitments; (ii) honor loan modification terms or forbear from exercising remedies after making promises; (iii) take actions required under loan documents or interpret loan documents properly.
- **Breach of Duty of Good Faith and Fair Dealing examples:** (i) refusing to release a deed of trust to pressure payoff; (ii) manipulating appraisal to trigger default.
- **Breach of Fiduciary / Special Duty:** (i) borrower has faith, confidence, and trust in the lender, (ii) the borrower is in an unequal position and has weakness or lack of knowledge, and (iii) the lender exercises dominion, control, or influence over the borrower's business affairs.
- **Economic Duress:** (i) a threatened action which the party has no legal right to do; (ii) that is of such character as to destroy the free agency of the other party, causing such party to do something not legally bound to do; and that (iii) effectuates an imminent restraint (iv) that the affected person has no other adequate legal remedy.

Bankruptcy-related claims

- **Fraudulent transfer:** transfers from an insolvent debtor to a secured creditor for nominal or no consideration may be deemed "sham" transactions and thus voidable as fraudulent transfers.
- **Insider status:** controlling lender may be considered an insider, subject to a duty to deal fairly and impartially with the borrower and its other creditors. *In re C-L Cartage Co.*, 899 F.2d 1490, 1492 (6th Cir. 1990).
- **Recharacterization:** intent may be inferred from the contract, actions, and economic reality of the surrounding circumstances. *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006).
- **Equitable subordination:** (1) misconduct; (2) injury to other creditors or unjustly improved position; and (3) subordination must not otherwise violate bankruptcy principles. § 510(c). *See In re Owens Corning*, 419 F.3d 195 (3d Cir. 2005).



Tools for Reallocating Value: Right Offering

Rights offerings provide a means for injecting capital to a reorganized debtor; however, they can also serve as a tool to reallocate value within the capital structure.

Pros

- **Capital infusion:** provides a means for capital infusion for the reorganized debtor, taking advantage of § 1145's exemption of securities registration.
- **Return on Investment:** provides parties in the capital structure to reclaim losses.
- **Equity participation:** permits equity holders an ability to provide new value and potentially satisfy 203 North LaSalle.
- **Incentives creative restructuring strategies:** the securities offered in a rights offering could be debt or equity securities.
- **Provides certainty:** backstop agreements provide the debtor certainty of plan funding, which assists with satisfying feasibility.
- **Obviates valuation disputes:** permits junior members of the capital structure to "put their money where their mouth is."

Cons

- **Control by a class subset:** sophisticated distressed players may control the rights offering process hoarding "goodies" for their constituents.
- **Disparate treatment:** creditors "under the tent" are able to negotiate exclusive participation rights or backstop fees, which are not always valued for purposes of § 1123(a)(4).
- **Trade creditor treatment:** trade creditors and unsophisticated parties are unlikely to provide additional capital to the debtor who owes it money, and thus their treatment may be unequal to other sophisticated but similarly situated creditors.
- **Accredited Investors:** participation in certain rights offerings may be limited to "Qualified Institutional Buyers" (QIBs).



Strategy and Timing of Using Tools

Active junior creditors can impact timing of bankruptcy proceedings including confirmation and effective date, which may result in different valuation depending on market fluctuations or other variables, and can maximize opportunities for settlement.

Statutory Authority

- § 7001: Adversary proceedings. Litigation involving enumerated matters, largely incorporating Federal Rules of Civil Procedure.
- § 2004 Examination and Production of Documents: On motion of any party in interest, the court may order the examination of any entity.
- § 1104(c) Appointment of Examiner. If the court does not order the appointment of a trustee, then at any time before the confirmation of a plan, any party in interest can request after notice and a hearing, appointment of an examiner.
- § 1129(a) Objection to Plan Confirmation.

Strategic Use

- Seek recovery against debtor for money or property, or obtain injunction or equitable relief. Obtain dispute-related information through discovery.
- Obtain documents and testimony relating to the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge.
- Investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management.
- Objection to plan that does not comply with the Bankruptcy Code, best interest test, good faith.



Strategy and Timing: Defining Value

Alternative solutions are available for active junior creditors that are open to considering value outside the traditional definitions and methods of recovery.

Delayed or Contingent Arrangements

- Warrants: Where the value of an entity is undetermined or disputed at effective date, warrants in the reorganized entity can be effective to provide junior creditors the opportunity to share in the future equity.
- Contingent Recovery: Where a junior creditor will only recover after senior or secured creditors are paid, a contingent recovery provides assurance that potential excess value will be distributed to creditors who may otherwise see no recovery.

Non-Monetary Value

- Injunctive or declaratory relief may be available through settlement of an adversary claim, and can sometimes provide more value to a contingent litigation creditor than monetary pay-out under the Plan.
- License agreements, leases, or other new or renegotiated contracts with the debtor can also provide value, particularly for litigation creditors that may continue doing business with the reorganized entity.



Redemption Option Value

In certain chapter 11 cases, the fortuity of the timing of the commencement of the case and of plan confirmation can significantly impact value allocations among creditors and other stakeholders. The ABI Commission's recommended principles propose a mechanism to adjust distributions to creditors to account for the possibility of future appreciation in the subject firm's value due to its continuation as a going concern

- The effective date of a plan of reorganization crystallizes the value of the debtor, and accordingly forecloses the possibility that certain "out of the money" stakeholders could obtain a recovery from the appreciation in firm value that could result from the firm's continuance as a going concern
 - Such stakeholders may lose their rights against the estate and receive no value on account of their claims simply because of the timing of the valuation of the enterprise in the chapter 11 case
- To mitigate this inequity (and associated litigation which can often be wasteful and time consuming), the Commission recommended that section 1129(b) be amended to provide that, subject to certain other conditions,
 - a) A chapter 11 plan may be confirmed over the non-acceptance of the class immediately junior to the "fulcrum" class if and only if such immediately junior class receives not less than the "redemption option value" (as defined below), if any, attributable to such class, and
 - b) A chapter 11 plan may be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely as a result of the distribution to an immediately junior class of the redemption option value, if any, attributable to such class

Term	Definition	Commentary
Redemption Option Value	▪ The value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price (as defined below) and a duration equal to the redemption period (as defined below)	▪ May be in the form of cash, debt, stock, warrants, or other consideration ▪ Form of consideration subject to the election of the senior class being required to give up such value
Redemption Price	▪ The full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate, plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option	▪ Strike price of the option determined such that the senior class or classes must be repaid in full before any redemption option value exists
Redemption Period	▪ The third anniversary of the petition date	▪ Assumed to be a reasonable time period over which most economic cycles, industry events, operational issues, etc. may be resolved



Redemption Value Calculation Based on S&P 500

The below chart depicts illustrative redemption option value sensitized to a range of volatilities and recovery values to the fulcrum class of senior debt

Assumptions		Redemption Option Value as a % of Reorganization Value			
Recovery % on Senior Debt		Volatility			
		20.7%	23.7%	26.7%	
	90.0	8.00	9.52	11.04	
	80.0	4.09	5.33	6.60	
	70.0	1.68	2.50	3.42	
	60.0	0.50	0.91	1.43	
	50.0	0.09	0.22	0.43	
Redemption Option Value as a % of Reorganization Value					

Source: Bloomberg, FactSet, and Federal Reserve Economic Data (FRED) as of March 2022.



On January 15, 2015, Caesars Entertainment Operating Company, Inc. ("Caesars" or the "CEOC") filed for Chapter 11 relief as a result of an over-levered capital structure and declining gaming conditions as a result of the macro-economic decline beginning in 2008

Background and Commentary

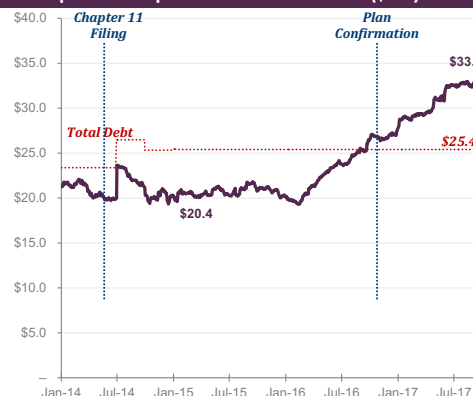
- The 2008 recession sent Caesars revenues down by over 23% from 2007 to 2009. Despite aggressive cost reduction, EBITDA fell by nearly half a billion dollars and hindered the company's ability to service its debt
- In the short-term, asset sales, new financings, and liability management transactions kept the company afloat, yet the leverage taken on in the LBO proved ultimately untenable
- While negotiations and litigation over prepetition asset transfers and liability management transactions dragged on, the Las Vegas market and gaming industry as a whole began to show signs of recovery
 - Over a year into the case, company-wide LTM EBITDA⁽²⁾ increased from \$1,462 million in 2014 to \$2,203 million as of September 30, 2017
 - Additionally, a corporate reorganization around an OpCo / PropCo structure unlocked incremental value
- CEOC filed four separate plans of reorganization, each successive plan with significantly increased consideration to creditors
- Junior creditors received the largest benefit from increased consideration, with 2L recoveries improving from 8% to 65%

Source: Bloomberg data as of October 2017.

(1) Imputed based on trading value of all debt and equity securities.

(2) Figures pro forma for closures and asset sales.

Market Implied Enterprise Value⁽¹⁾ (\$BN)



On May 22, 2020, Hertz Corporation ("Hertz" or the "HTZ"), a leading global vehicle rental company, filed for chapter 11 as a result of the COVID-19 pandemic's impact on travel demand

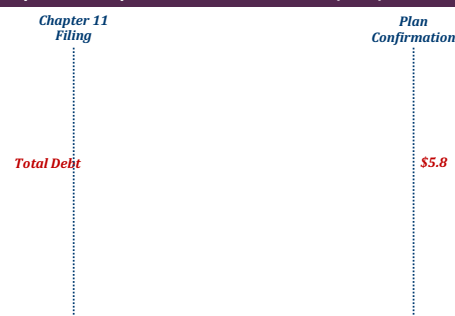
Background and Commentary

- With an extensive network of on-airport and off-airport rental locations in the US and all major European markets, Hertz historically benefitted from favorable long-term travel industry trends
 - Strong growth and performance trajectory prior to 2020 economic disruption
- At the onset of the COVID-19 pandemic, lockdowns, border closures and mandatory quarantines sent shockwaves throughout the travel industry as both business and leisure travel came to a halt
- Yet, as the Chapter 11 case continued, Hertz benefitted from recovering rental car demand, increasing used vehicle demand and a shift away from public transit use
 - In addition to rental services, Hertz is one of the largest used car dealers in the U.S.
- The initial Plan of Reorganization provided for a 70% cash recovery to unsecured claims and no recovery to common equity holders. The ultimate Plan provided for 100% cash recovery to unsecured claims and meaningful recovery to common equity

Source: Bloomberg data as of December 2020 and March 2022, Company website.

(1) Imputed based on trading value of all debt and equity securities. Due to limited data availability, after December 3, 2020 Senior Credit Facilities assumed to be trading at par (96.0% weighted average trading price at December 3, 2020), and 2022 - 2028 Senior Notes based on 5.500% Senior Notes due 2024 price through emergence.

Market Implied Enterprise Value⁽¹⁾ (\$BN)



2014

Final Report of the ABI Commission to Study the Reform of Chapter 11

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COMMISSION TO STUDY THE REFORM OF CHAPTER 11

2012~2014

FINAL REPORT AND RECOMMENDATIONS

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I. INTRODUCTION

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

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

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

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

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

² I. INTRODUCTION

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

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

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

Although the Commission designed its three-year process around concepts of inclusiveness, diversity of thought, leadership, and transparency, the Commission, working with the Commission's Reporter, Professor Michelle M. Harner, University of Maryland Francis King Carey School of Law, maintained exclusive control over the substance of the final Report. All decisions and recommendations set forth in the Report were made solely by the Commissioners in accordance with the voting procedures described herein. The Reporter worked closely with the Commissioners to draft the language of the recommended principles and the supporting narrative for each of those principles. Although the Reporter acted as the principal draftsman of the Report, the Commissioners reviewed and commented on various iterations of this Report to achieve this final product. The Commission voted unanimously to adopt this Report on December 1, 2014. During the three-year study and the drafting process, the Commission was assisted in its research by Leah Barteld Clague, Jennifer Ivey-Crickenberger, and Sabina Jacobs, as well as each of the Commission's advisory committees and their respective reporters. The Commission appreciates the assistance of all of these individuals, and acknowledges the substantial value added to this Report by the work of the advisory committees and the international working group.³

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

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

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II. EXECUTIVE SUMMARY OF PROPOSED PRINCIPLES

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

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

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

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



III. BACKGROUND ON THE COMMISSION AND THE STUDY PROJECT

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

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

The United States has one of the strongest and most well developed business reorganization schemes in the world.⁷ This business reorganization scheme has a rich history, stemming in large part from the railroad failures of the late 19th century.⁸ The Bankruptcy Acts of 1867 and 1898 introduced the basic conceptual underpinnings of modern bankruptcy law, including business bankruptcy.⁹ These laws, particularly the 1898 Bankruptcy Act, were grounded in a “rescue and rehabilitate” policy intended to allow the honest but unfortunate debtor, including the business debtor, to obtain a fresh start and a second chance at becoming a productive, contributing member of society.¹⁰ As with all U.S. bankruptcy laws, the 1898 Bankruptcy Act sought to balance the need of the debtor

⁵ See, e.g., Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 18–23 (1995).
⁶ One commentator explained:

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

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

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

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

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

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

8 III. BACKGROUND ON THE COMMISSION AND THE STUDY PROJECT

to rehabilitate and the rights of creditors to recoveries. The basic notion that a business generally is more valuable to creditors and society as a whole if it rehabilitates rather than liquidates also emerged during this period.¹¹

Bankruptcy law progressed in response to, among other things, the Great Depression of the 1930s,¹² and a more formalized process evolved that allowed distressed companies to remain in business while restructuring their obligations.¹³ These developments produced Sections 77 and 77B of the Bankruptcy Act¹⁴ and then the Bankruptcy Code's immediate predecessor, the Chandler Act,¹⁵ which added three new chapters for reorganizing ongoing businesses (Chapters X and XI concentrated on businesses, and Chapter XII addressed real estate organizations).¹⁶ Each iteration of the law focused on strengthening business reorganizations and seeking an appropriate balance between the rights and obligations of the debtor and its stakeholders.

Under Chapter X of the Chandler Act, a trustee was appointed to replace the debtor's management, and the Securities and Exchange Commission had a formal oversight role in the reorganization process.¹⁷ The large public companies subject to Chapter X did not embrace these two requirements.¹⁸ They worked to avoid a bankruptcy filing — even when arguably necessary or prudent under the circumstances — or tried to come within the provisions of Chapter XI of the Chandler Act.¹⁹ Chapter XI was intended for smaller, nonpublic companies and only addressed unsecured debt in the debtor's capital structure. Nevertheless, companies generally preferred this chapter because it

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

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

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

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

15 “[The Chandler Act] was far-reaching in its scope and purpose. The Act comprised 15 chapters; the first seven chapters dealt with the liquidation provisions substantially based upon the original 1898 Act while chapters eight through fifteen dealt primarily with the rehabilitation of various classes of debtors.” Kennedy & Clift, *supra* note 13, at 176. For a detailed history and analysis of the Chandler Act, see Vincent L. Leibell, Jr., *The Chandler Act — Its Effect Upon the Law of Bankruptcy*, 9 Fordham L. Rev. 380, 385–409 (1940).

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

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

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

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

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placed the reorganization largely in the hands of the debtor and its unsecured creditors' committee and was premised on the efforts of these parties to structure a negotiated resolution to the debtor's financial distress.²⁰ After almost 40 years of restructuring experience under Chapter X and Chapter XI of the Chandler Act, policymakers and practitioners agreed that reform was needed.²¹

Consequently, in 1970, Congress created the Commission on the Bankruptcy Laws of the United States (the "**Commission on Bankruptcy Laws**") to "study, analyze, evaluate and recommend changes to the [1898] Act."²² In 1973, the Commission on Bankruptcy Laws issued a report and a draft of proposed bankruptcy legislation.²³ The National Conference of Bankruptcy Judges, excluded from the Commission on Bankruptcy Laws, submitted a competing legislative proposal.²⁴ President Carter ultimately signed into law the 1978 Bankruptcy Code, which combined various concepts from both legislative proposals and merged Chapters X, XI, and XII of the 1898 Bankruptcy Act into a single business reorganization chapter (the current chapter 11).²⁵ In passing the Bankruptcy Code, Congress believed that "the purpose of a business reorganization case [under chapter 11] . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders"²⁶ with the understanding that "reorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders."²⁷

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

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

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

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

23 Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137 (1st Sess. 1973). See also *Report*, *supra* note 22; Frank R. Kennedy, *The Report of the Bankruptcy Commission: The First Five Chapters of the Proposed New Bankruptcy Act*, 49 Ind. L.J. 422 (1974).

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

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

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

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

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

29 See *id.* § 2:12.

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

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

32 See *id.* § 2:14.

33 See *id.* § 2:15.

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12.³⁴ In 1994, Congress again added various provisions, including changes in time limits, exemptions, and criminal penalties.³⁵

In 1994, Congress also created the National Bankruptcy Review Commission (the “**NBRC**”) to foster a more systemic look at studying and reforming the Bankruptcy Code.³⁶ The NBRC issued its report in 1997,³⁷ and several of its recommendations were addressed to varying degrees in the amendments to the Bankruptcy Code set forth in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “**BAPCPA Amendments**”).³⁸ BAPCPA implemented an extensive overhaul of both the business and consumer provisions of the Bankruptcy Code.³⁹

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

³⁴ See *id.* § 2:16.

³⁵ See *id.* § 2:17.

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

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

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

³⁹ Lubben, *supra* note 9, at 407–08.

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

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

B. The Need for Reform

Chapter 11 of the Bankruptcy Code has served us well for many years. Nevertheless, today's financial markets, credit and derivative products, and corporate structures are very different than those existing in 1978 when Congress enacted the Bankruptcy Code. Companies' capital structures are more complex and rely more heavily on leverage, which is secured under state enactments of the Uniform Commercial Code that encumber vastly more assets than in 1978;⁴² their asset values are driven less by hard assets (e.g., real estate and machinery) and more by services, contracts, intellectual property, and other intangible assets; and both their internal business structures (e.g., their affiliates and partners) and external business models are increasingly multinational. In addition, claims trading and derivative products have changed the composition of creditor classes. Although these developments are not unwelcome or unhealthy, the Bankruptcy Code was not originally designed to rehabilitate companies efficaciously in this complex environment.⁴³

Moreover, anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and medium-sized enterprises) and is no longer capable of achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases at both the state and federal level, or helping to rehabilitate viable companies that cannot afford a chapter 11 reorganization.⁴⁴ Some professionals suggest that more companies are liquidating or simply closing their doors without trying to rehabilitate under the federal bankruptcy laws.⁴⁵ Commentators and professionals also suggest that companies are waiting too long to invoke the federal bankruptcy laws, which limits companies' restructuring alternatives and may lead to premature sales or liquidations.⁴⁶

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

43 See, e.g., Ralph Brubaker, *The Post-RadLAX Ghosts of Pacific Lumber and Philly News (Part II): Limiting Credit Bidding*, Bankr. L. Letter, July 2014, at 4 ("Two monumental developments in Chapter 11 practice that the Code drafters likely did not anticipate, though, have skewed negotiations over allocation of reorganization surplus decisively in favor of senior secured creditors, in a manner that the Code drafters also likely did not anticipate. The first is the ascendancy of secured credit in Chapter 11 debtors' capital structures, such that it is now common that a dominant secured lender has blanket liens on substantially all of the debtor's assets securing debts vastly exceeding the value of the debtor's business and assets. The second, related phenomenon is the rise of 'relatively expeditious going-concern sales of the debtor's business and assets to a third-party purchaser' as a prominent means of realizing the debtor's going-concern value in Chapter 11.") (citations omitted).

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

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

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

Not all commentators agree that significant reform to chapter 11 is necessary. Some suggest that any changes could have unintended consequences or negatively impact credit markets. Others simply suggest that the system continues to work well enough.⁴⁷

These issues are at the heart of the Commission's study. As explained below, the Commission's process was designed to explore the new environment in which financially distressed companies operate and to determine what aspects of the current system are — and are not — working as well as possible.

C. The Commission's Study

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

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

The Commission has met on a regular basis since January 2012. During these meetings, the Commission has, among other things, discussed issues perceived as potential problems in chapter 11, reviewed recent developments in the case law and practice norms, and developed an effective process for identifying, researching, and analyzing chapter 11 as a whole. As explained below, the Commission used its advisory committees and numerous public field hearings to amass the information and research it required to critically analyze chapter 11 and consider any reform measures.

The Advisory Committees. To launch its study, the Commission identified 13 broad study topics to facilitate a detailed analysis of the various components of chapter 11. These study topics are: (1) administrative claims and other pressures on liquidity; (2) avoiding powers (e.g., preferences and fraudulent conveyances); (3) bankruptcy-remote and bankruptcy-proof entities; (4) distributional issues under plans; (5) executory contracts and unexpired leases; (6) financial contracts, derivatives,

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

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

⁴⁹ See *id.* at 61.

⁵⁰ See *id.* at 63.

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and safe harbors; (7) financing issues; (8) governance and supervision of cases; (9) labor and benefits issues; (10) multiple entities and corporate groups; (11) procedural and structural issues under plans; (12) role of valuation; and (13) asset sales in chapter 11.⁵¹ The Commission then enlisted the volunteer service of more than 150 of the insolvency profession's expert judges, lawyers, financial advisors, academics, and consultants to serve on advisory committees for each of these study topics.⁵²

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

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

The Commission then held a three-day retreat in February 2014 to meet with each advisory committee and discuss the research reports. At the retreat, the advisory committees presented their reports and highlighted complex and nuanced issues for the Commission, and the Commissioners actively engaged in a direct dialogue with advisory committee members. The Commission also used the forum to begin integrating the study topics and reconciling overlapping issues. The retreat and the work of the advisory committees leading up to the retreat sessions were informative and very helpful to the Commission in this process. Since then, the Commission has reviewed the entire body of work produced by the advisory committees and conducted follow-up research and analysis on a variety of issues.

The Commission also formed an international working group consisting of leading practitioners and academics from 13 different countries.⁵³ The working group has studied targeted questions posed

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

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

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

by the Commission and the advisory committees to provide a comparative analysis of the relevant issues. These questions generally involved the following broader topics: (i) the use of surcharges in sales; (ii) the treatment of intellectual property licenses in insolvency; (iii) financing options for insolvent companies; (iv) the role of administrators and monitors; (v) plan issues (presenting, voting, plans variations, and allocation rules); (vi) creditors' or stakeholders' committees; and (vii) claims trading.

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

Several common themes emerged from the field hearings. First, many witnesses acknowledged that chapter 11 cases have changed over time.⁵⁶ These changes include: (1) a perceived increase in the number and speed of asset sales under section 363 of the Bankruptcy Code;⁵⁷ (2) a perceived decrease in stand-alone reorganizations; (3) a perceived decrease in recoveries to unsecured creditors;⁵⁸ and (4) a perceived increase in the costs associated with chapter 11.⁵⁹ Second, the witnesses who testified on issues relating to small and medium-sized enterprises generally opined that chapter 11 no longer

Elliott (Australia), C. Fell, M. Rochkin, S. Obal and Professor J. Sarra (Canada), L. Valentovich (Japan), L. Harms (South Africa) and C. E. Poolis (England).

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

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

56 See *Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 15–19 (Oct. 26, 2012) (NCBJ Transcript) (“There is a gradual erosion of the underlying public principle of the Code which was to preserve jobs and maximize value through rehabilitation.”), available at Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 2 (Nov. 15, 2012) (“[A] principal criterion for evaluating any proposed amendments to the Code is the extent to which they maximize the value of companies as going concerns (thereby preserving jobs and maximizing value for creditors), either through a reorganization in those situations where reorganization is a realistic option, or through a sale or liquidation where reorganization is not a realistic option.”), available at Commission website, *supra* note 55.

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

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

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

works for these companies. Witnesses cited cost and procedural obstacles as common barriers.⁶⁰ Third, the witnesses who testified on financial contracts and derivatives generally agreed that the safe harbor protections have been extended to contracts and situations beyond the original intent of the legislation.⁶¹ They did not necessarily agree, however, on appropriate limitations or revisions to the relevant sections of the Bankruptcy Code.⁶² Finally, witnesses — even those who were highly critical of certain aspects of chapter 11 — all perceived value in the U.S. approach to corporate bankruptcies, including the debtor in possession model.⁶³

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

D. The Commission's Deliberations

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

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

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

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

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

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

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

Virginia, two in New York, and one in Chicago. The Commission also held numerous subcommittee meetings in between each of these executive session retreats.

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

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

The recommended principles set forth in this Report are the result of the Commission's study and deliberative process. The Commissioners voted on each principle, and a principle was adopted as a Commission recommendation if it received support from two-thirds of the Commissioners voting, with 11 favorable votes being the minimum required for a principle being reported as a

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

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recommendation. If the requisite level of support was not obtained, this Report includes a description of the issue, a summary of the factors considered by the Commission in connection with the issue, and a notation that no consensus emerged. The Commission believed that this Report achieves its core mission to “study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders.”⁶⁷

⁶⁷ See Commission’s mission statement, *supra* at 3.



IV. PROPOSED RECOMMENDATIONS: COMMENCING THE CASE

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

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

Witnesses before the Commission testified concerning the various perceived barriers to successful reorganizations under chapter 11, including challenges to financing chapter 11 cases, uncertainty and costs associated with the bankruptcy process, delays built into the process, and insufficient value available to support a restructuring.⁷³ Some witnesses suggested that these perceived barriers may cause companies to forego the chapter 11 process entirely.⁷⁴ Anecdotal evidence likewise indicates that distressed companies are increasingly turning to state law remedies (*e.g.*, receiverships and assignments for the benefit of creditors) and equity receivership law with more frequency now

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

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

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

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

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

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

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

than in the past 75 years.⁷⁵ Moreover, there is no meaningful way to discern how many distressed companies that could have used chapter 11 simply closed their doors instead of pursuing alternatives through the reorganization process.

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

A. Oversight of the Case

1. The Debtor in Possession Model

Recommended Principles:

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

The Debtor in Possession: Background

A fundamental feature of chapter 11 of the Bankruptcy Code is the “debtor in possession” concept. This feature allows the financially distressed company to remain in control of its assets and to continue to operate its business after commencing the chapter 11 case. Accordingly, on the petition date, the company assumes the new legal capacity of a “debtor in possession.”⁷⁶

In a typical chapter 11 case, the debtor in possession's prepetition board of directors and officers will continue to manage the debtor's affairs and make decisions regarding both the debtor's business and its reorganization efforts in the chapter 11 case. The debtor in possession model was expanded by

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

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

chapter 11 in the 1978 Bankruptcy Code from the company's active role in the rehabilitation process under Chapter XI (but not Chapter X) of the 1898 Bankruptcy Act.⁷⁷ Practice under the Bankruptcy Act suggested that boards of directors and management resisted a process — even if arguably beneficial to their restructuring efforts — that required them to cede control of their business and restructuring efforts to an outside party. This requirement contributed in part to the failure of Chapter X of the Bankruptcy Act because it mandated the appointment of a trustee to run the debtor's business and bankruptcy case.⁷⁸ Notably, section 1107 of the Bankruptcy Code authorizes the debtor in possession to, among other things, exercise all “the rights . . . and powers, and [requires it to] perform all the functions and duties . . . of a trustee serving in a case under this chapter,” with only minor exceptions that do not detract from the central role of the debtor in possession in the case.⁷⁹

Proponents of the debtor in possession model highlight the knowledge and expertise of the debtor's prepetition directors, officers, or similar managing persons concerning the debtor's business and financial affairs.⁸⁰ The ability of the debtor in possession to continue to operate through its prepetition management team facilitates the company's seamless transition into chapter 11 and allows the debtor to avoid the additional time, cost, and resulting inefficiencies of bringing in an outsider who is not familiar with the debtor's business specifically or the debtor's industry generally.⁸¹ The prepetition management team may also have industry relationships or “know-how” that would benefit the debtor's restructuring efforts.

Critics of the debtor in possession model note that the debtor's financial or operational difficulties may relate, at least in part, to the conduct or decisions of the debtor's prepetition directors and officers.⁸² Some critics argue that allowing the management team that was in charge during the debtor's financial decline to remain in control rewards subpar performance and undermines confidence in the reorganization process for the debtor's stakeholders.⁸³ Some critics also worry that prepetition management may be motivated by factors not necessarily aligned with the best interests

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

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

79 11 U.S.C. § 1107.

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

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

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

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

of the estate, such as retaining their jobs or downplaying prepetition events that may implicate them in the debtor's financial distress.⁸⁴

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

The Bankruptcy Code also places certain checks on the debtor in possession's power and decision-making authority in chapter 11. For example, the debtor in possession may be replaced by a trustee for cause; a statutory unsecured creditors' committee frequently is appointed to oversee the debtor in possession's conduct and to represent the interests of unsecured creditors; major decisions and transactions require notice, hearing, and court approval; and the U.S. Trustee and parties in interest have standing to raise and be heard on matters in the case.⁸⁶ In addition, the directors, officers, or similar managing persons of the debtor in possession are bound by their state law fiduciary duties.⁸⁷

The Debtor in Possession: Recommendations and Findings

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

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

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

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

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

administrator. Moreover, the trustee, receiver, or administrator could terminate the employment of the debtor's management altogether.

The Commissioners debated the potential utility of a third-party manager to the bankruptcy estate. The Commission determined that these third-party alternatives could add the most value to cases involving fraudulent or incompetent management. The Commissioners acknowledged, as discussed further below, that section 1104 of the Bankruptcy Code currently mandates the appointment of a trustee in such cases.⁸⁸ The Commission also considered that in recent years many countries have adopted some form of the debtor in possession model either in lieu of or as an alternative (at the company's election) to a receiver or administrator.⁸⁹ This trend suggests broad recognition of the potential benefits of allowing the honest-but-unfortunate company debtor to lead its own restructuring efforts. Thus, on balance, the Commission concluded that the potential value of a mandatory trustee-like actor was significantly outweighed by the potential disruption, costs, and inefficiencies associated with the displacement of the debtor's management. Accordingly, the Commission recommended retention of the debtor in possession model.

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

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

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

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

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

The Commissioners also discussed the potential conflicts in duties that could result from federalizing the fiduciary duties of directors, officers, and similar managing persons. For example, most state laws provide that directors, officers, and similar managing persons owe a fiduciary duty to the company, which is enforceable by its shareholders when the company is solvent and also by its creditors when it is insolvent.⁹² Some courts have suggested that this allocation of rights between shareholders and creditors shifts as a company approaches insolvency (*i.e.*, the “zone of insolvency”), but many courts tend to maintain the *status quo* until the company becomes insolvent.⁹³ If the Bankruptcy Code imposed separate duties on a debtor in possession’s directors, officers, or similar managing persons, those duties might differ from the duties owed by those individuals under state law. Although federal preemption principles might resolve such conflicts from a legal perspective, the conflict could cause substantial confusion and uncertainty for directors, officers, and similar managing persons. The Commission agreed that state law adequately governs fiduciary duties and should continue to govern the fiduciary duties of directors, officers, and similar managing persons in bankruptcy.

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

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

2. The Chapter 11 Trustee

Recommended Principles:

- The standard for appointing a chapter 11 trustee under section 1104(a) of the Bankruptcy Code should not change.
- The burden of proof with respect to requests for the appointment of a chapter 11 trustee under section 1104(a) should be based on the preponderance of the evidence standard. Case law requiring application of the clear and convincing standard should be overturned by statutory amendment.
- As is currently provided by section 1104(d), the U.S. Trustee should continue to select and appoint a disinterested person to serve as chapter 11 trustee after the court enters an order under section 1104(a) directing such appointment and after consultation with parties in interest.⁹⁴
- A party in interest should be able to object to the person appointed as the chapter 11 trustee. An objecting party should plead with particularity the facts supporting its objection. The objection should be filed and heard on an expedited basis. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321; (3) the person selected has not qualified to serve as trustee under section 322; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. If an objection is filed, the court should approve or disapprove the person appointed as chapter 11 trustee by the U.S. Trustee, but the court should not otherwise be involved in the chapter 11 trustee selection process.
- Section 1104(b), which provides for the election of a chapter 11 trustee, should be deleted.
- Once appointed, the chapter 11 trustee may take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders.
- The appointment of a chapter 11 trustee should not terminate the debtor's exclusivity period to file, or its time to solicit acceptances of, a plan, but should preserve such exclusivity period solely for the benefit of the trustee. Accordingly, the trustee should receive the benefit of any remaining exclusivity period under section 1121, provided that a party in interest should be able to file a motion seeking to shorten or terminate such period as provided in section 1121(d). Section 1121(c)(1) should be amended accordingly.

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

The Chapter 11 Trustee: Background

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

Notwithstanding this statutory authority, anecdotal evidence suggests that chapter 11 trustees are the rare exception rather than the rule.⁹⁷ The paucity of cases in which chapter 11 trustees serve may suggest that the overall system is working and that stakeholders either have confidence in the debtor’s management or have replaced troublesome managers prior to or shortly after the petition date.⁹⁸ Parties in interest may also be using the possibility of seeking the appointment of a trustee in negotiations with the debtor in a way that fosters meaningful results and eliminates the need for a trustee.⁹⁹ A case warranting a chapter 7 trustee may convert to a case under chapter 7 of the Bankruptcy Code, thereby eliminating the need for a chapter 11 trustee.¹⁰⁰ Some contend that a systemic antipathy to reorganization trustees, arising from pre-Bankruptcy Code practice, found its way into early decisions that construed the language of the Bankruptcy Code.¹⁰¹ For example, courts may be discouraging parties from filing motions requesting the appointment of a chapter 11 trustee by applying the clear and convincing standard to the determination.¹⁰² Parties in interest also may fear retribution by the debtor or other stakeholders if the court denies the motion, or may prefer having individuals with whom they are familiar (even if they do not like or necessarily trust them) rather than an individual they do not know. Moreover, some parties may raise concerns regarding the costs associated with chapter 11 trustees, which may be driven by a perception that chapter 11 trustees are inclined toward litigation to ensure that they fulfill their fiduciary duties to the estate.¹⁰³

If the court enters an order appointing a chapter 11 trustee, the U.S. Trustee identifies a disinterested and qualified individual to serve as the trustee.¹⁰⁴ Section 1104(d) requires the U.S. Trustee to

⁹⁵ 11 U.S.C. § 1104(a)(1), (2).

⁹⁶ *Id.* § 1104(e).

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

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

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

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

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

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

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

¹⁰⁴ See Clifford J. White III & Walter W. Theus, Jr., *Taking the Mystery Out of the Chapter 11 Trustee Appointment Process*, Am. Bankr. Inst. J., May 2014 (“Beyond independence, the U.S. Trustee will consider a candidate’s experience, qualifications and ability to

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

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

The Chapter 11 Trustee: Recommendations and Findings

The debtor in possession model should not be the sole structure for a chapter 11 case. The Bankruptcy Code needs an effective mechanism for appointing a chapter 11 trustee to displace management in appropriate cases. The Commissioners discussed the kinds of cases that warrant chapter 11 trustees, including instances of fraud or illegal conduct by management. They also acknowledged the value of appointing a trustee to increase accountability in chapter 11 cases, to protect against "bankruptcy rings" and collusive conduct, and to create dynamic tension by introducing an outsider to the negotiation process.¹⁰⁸ As referenced in the previous section, however, the Commissioners also evaluated the potential disadvantages of appointing a trustee, such as the potential collateral impact of the appointment, additional costs, delays, and inefficiencies in the case. In light of the foregoing, the Commission determined to retain the grounds for the appointment of a chapter 11 trustee set forth in section 1104(a) because they are warranted and strike an appropriate balance between the benefits and drawbacks of such appointment.

The Commission also considered the relatively low percentage of trustee appointments in chapter 11 cases. It was not able to determine if the relatively small number of trustee appointments suggested a flaw in the current system or reflected the judgment of stakeholders that grounds either did not exist to support an appointment or were remedied through prepetition changes

muster necessary bankruptcy, financial and business expertise."). Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions.

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

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

107 *Id.* § 1106(a).

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

in management. The Commissioners were persuaded by the suggestion that the burden of proof governing a motion to appoint a chapter 11 trustee under section 1104 could influence the decision of a party in interest to file such a motion in the first place. Indeed, courts often expressly state that the appointment of a chapter 11 trustee is the exception and that the standard for approval is very high.¹⁰⁹ The Commissioners evaluated the potential chilling effect of requiring the moving party to demonstrate the need for a trustee by clear and convincing evidence and the justifications for this standard.¹¹⁰ They also discussed whether a lower standard, such as the preponderance of the evidence standard, could be subject to abuse and cause unnecessary distractions in the chapter 11 case.

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

The Commissioners also discussed their various experiences with trustees in chapter 11 cases and acknowledged that, particularly in cases involving massive fraud by the debtor, chapter 11 trustees have served with distinction.¹¹¹ They discussed the value of having the U.S. Trustee, as an independent agency with no financial stake in the case, identify and vet trustee candidates, because multiple stakeholders may have competing interests in the selection process.

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

The Commission considered whether the election process incorporated into section 1104(b) provides stakeholders with a sufficient alternative to a candidate selected by the U.S. Trustee. In theory, the election process should enable stakeholders to nominate directly and then to vote on

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

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

¹¹¹ But see *Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (“MFA therefore suggests that Congress should make clear that parties in interest and the U.S. Trustee may seek appointment of a trustee in circumstances other than fraud – where management entrenchment, misalignment of interests or other factors have significantly impaired the reorganization process such that a neutral third party is necessary to break the logjam. Appointment of a trustee should be authorized if the court believes that a trustee will be better equipped than management to navigate competing interests and facilitate a successful reorganization. The preference of all creditors should be taken into account – both in the appointment of an interim trustee and in any subsequent election.”).

qualified candidates. Unfortunately, the anecdotal evidence suggests that stakeholders rarely request an election process and are skeptical that the process benefits the estate for at least two reasons. First, it is hard to displace a trustee that has already been put in place, even if a different person with greater support among the constituents might have been picked in the first instance. Second, several of the major constituencies are not entitled to vote under section 1104(b), including secured creditors and unions.¹¹²

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

Section 1104(d) provides for court approval of the U.S. Trustee's trustee appointments, but does not specify any grounds upon which the court may disapprove an appointment. Furthermore, parties in interest are given no role in the appointment approval process. The Commission concluded that specifying grounds for disapproval and providing stakeholders with a more defined ability to object to the U.S. Trustee's appointment would be beneficial. The Commissioners explored how to discourage frivolous objections and to encourage full disclosure in a manner that informed the parties and the court about the issues relevant to the appointment of the trustee. The Commission determined that any objections should be pled with particularity and that the objection process should incorporate a strong presumption favoring the U.S. Trustee's candidate. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321 of the Bankruptcy Code; (3) the person selected has not qualified to serve as trustee under section 322 of the Bankruptcy Code; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. A court should not reject the U.S. Trustee's selection based on a party in interest's assertion that another individual would better serve the estate or is better qualified for the position. Moreover, neither the court nor the objecting party should be able to displace the U.S. Trustee in the appointment process. The court should only be able to approve or disapprove the U.S. Trustee's appointment. If the court disapproves an appointment, the U.S. Trustee should still maintain control of the appointment process by vetting additional candidates and making a substitute appointment.

Once a chapter 11 trustee has been appointed, the Commission found that the current process works for vesting the trustee with all control and management authority concerning the debtor and the estate. Specifically, if grounds exist to warrant the appointment, the chapter 11 trustee

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

should be able to take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders. Accordingly, the chapter 11 trustee should, for example, be able to cause the estate to retain managers and employees deemed necessary to the reorganization process, but such personnel should act only under the supervision of the trustee.

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

In discussing the chapter 11 trustee appointment process, as well as the estate neutral appointment process described below, the Commission considered the current dual system for bankruptcy administration: (i) U.S. Trustees for 48 states, Puerto Rico, the U.S. Virgin Islands, and Guam; and (ii) Bankruptcy Administrators for Alabama and North Carolina. The Office of the U.S. Trustee operates as a division of the Department of Justice, and the Executive Office for U.S. Trustees coordinates and oversees the activities of the U.S. Trustees in 21 regional offices.¹¹³ This structure promotes uniformity and consistency in the application of federal bankruptcy laws. The Bankruptcy Administrator programs are separately administered in each state through the judiciary in those states.¹¹⁴

The Commissioners debated the efficiency of continuing these two separate systems. Some Commissioners believed that unifying the administration and oversight of bankruptcy cases in all jurisdictions under the Office of the U.S. Trustee would promote the uniformity in the application of federal bankruptcy laws as envisioned by the Bankruptcy Clause of the Constitution¹¹⁵ and would serve the interests of parties in the system. They encouraged the Commission to recommend making the U.S. Trustee program a national program that would be responsible for bankruptcy administration in all 50 states, as well as Puerto Rico, the U.S. Virgin Islands, and Guam. Other Commissioners expressed a concern that this issue was not directly within the scope of the Commission's mandate. Consequently, the Commission decided not to address this matter.

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

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

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

3. The Estate Neutral

Recommended Principles:

- The Bankruptcy Code should be amended to delete any reference to an “examiner” and to incorporate the concept of a more flexible “*estate neutral*,” as described in these principles.
- Section 1104(c) of the Bankruptcy Code should be amended to set forth the standards for, and potential authority and duties of, an estate neutral, as described in these principles.
- Section 1104(c) should not mandate the appointment of an estate neutral in any circumstances.
- The court should be permitted to order the U.S. Trustee to appoint an estate neutral if (i) a trustee is not appointed and (ii)(a) the appointment is in the best interests of the estate, or (b) for cause.¹¹⁶
- An order directing the U.S. Trustee to appoint an estate neutral should specify the scope of the estate neutral’s duties and the duration of the appointment. The court may direct the U.S. Trustee to appoint more than one estate neutral in any given case to serve different functions if necessary or warranted by the circumstances of the case. Nevertheless, the Bankruptcy Code should include a presumption against the appointment of more than one estate neutral in any given case.
- An order directing the U.S. Trustee to appoint an estate neutral should not permit that individual to: (i) propose a chapter 11 plan for the debtor; (ii) act as a mediator in any matter affecting the chapter 11 case, unless such action is the primary purpose of the individual’s original appointment; (iii) initiate litigation on behalf of the debtor or the estate, unless such action is within the scope of the individual’s original appointment and the individual was not previously engaged to investigate or examine matters relating to the litigation or the debtor’s chapter 11 case; or (iv) except as provided in the principles for small and medium-sized enterprise cases, operate the debtor’s business.
- Upon the entry by the court of an order directing the U.S. Trustee to appoint an estate neutral, the U.S. Trustee should, in conformity with the procedures established for the appointment of a chapter 11 trustee, appoint a disinterested person to serve as the estate neutral. A party in interest should have the ability to object to the person appointed as the estate neutral under the same procedures and subject to the same standards established in the principles governing objections to the person appointed as the chapter 11 trustee. *See* Section IV.A.2, *The Chapter 11 Trustee*.

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

The Estate Neutral: Background

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

Whether the appointment of an examiner is truly mandatory in any given case has met with resistance by some courts and created a split in the law.¹¹⁹ Professor Jonathan C. Lipson reviewed “dockets from 576 of the largest chapter 11 cases commenced between 1991 and 2007” and discovered that “examiners were requested in only 87 cases, or about 15 percent of the sample,” and that the “motions were granted in only 39 cases, less than half of cases where [an examiner was] sought, and about 6.7 percent of all cases in the sample.”¹²⁰ Professor Lipson concluded that despite statements by some commentators to the contrary, examiners “are neither ‘routinely’ sought nor ‘automatically’ appointed in large cases.”¹²¹ Professor Lipson also concluded that examiners were more likely appointed in “huge,” contentious cases, and that a request for the appointment of a trustee increases the odds that an examiner will be appointed.¹²²

Setting aside the debt threshold in section 1104(c)(2), courts have generally interpreted the “interests” test in section 1104(c)(1) to broadly encompass the interests of all parties in interest. As one court explained, “the basic job of an examiner is to examine, not to act as a protagonist in

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

118 11 U.S.C. § 1104(c).

119 See, e.g., *In re Wash. Mutual, Inc.*, 442 B.R. 314, 324 (Bankr. D. Del. 2011) (“The Court denied the Initial Examiner Motion . . . finding that there was no appropriate scope for an examiner to conduct an investigation given that issues pertinent to, and even beyond the scope of, the chapter 11 cases had been ‘investigated to death.’”); *In re Spansion, Inc.*, 426 B.R. 114, 127 (Bankr. D. Del. 2010) (“I find no sound purpose in appointing an examiner, only to significantly limit the examiner’s role when there exists insufficient basis for an investigation. To appoint an examiner with no meaningful duties strikes me as a wasteful exercise, a result that could not have been intended by Congress.”); *In re Erickson Ret. Communities, LLC*, 425 B.R. 309, 312 (Bankr. N.D. Tex. 2010) (“At first blush, the issue here seems to be whether, because the \$5 million unsecured debt threshold is met . . . the appointment of an examiner is mandatory. Many courts have been confronted with this issue and have held yes — an examiner is required whenever the \$5 million unsecured debt threshold of Section 1104(c)(2) is met. This court agrees with such courts that, where the \$5 million unsecured debt threshold is met, a bankruptcy court ordinarily has no discretion. The only judicial discretion that comes into play is in defining the scope of the examiner’s role/duties. The court can make the scope of an examiner’s duties very broad or very narrow.” (citations omitted)); *In re Vision Dev. Grp. of Broward Cnty, LLC*, 2008 WL 2676827, at *3 (Bankr. S.D. Fla. Jun 30, 2008) (“[A] request for, and appointment cannot be waived by request made late in case of, an examiner may be made ‘at any time before the confirmation of the plan.’” (quoting 11 U.S.C. § 1104(c)(2)). See also *Walton v. Cornerstone Ministries Invs., Inc.*, 398 B.R. 77, 81 (N.D. Ga. 2008) (“[E]very district court and nearly every bankruptcy court that has confronted the question has also read the provision to be mandatory on its face.”); *In re Schepps Food Stores, Inc.*, 148 B.R. 27, 30 (S.D. Tex. 1992) (“This reasoning is both grammatically and contextually wrong. In the provision, ‘as is appropriate’ modifies ‘investigation.’ The statute allows the court to determine the scope, length, and conduct of the investigation, rather than the appointment itself.”).

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

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

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

the proceedings.”¹²³ For this reason, “appointment under § 1104(c)(1) must, therefore, be in the interests of everyone with a stake in the case, including creditors, equity security holders, and other interests of the estate.”¹²⁴ When only certain parties (*i.e.*, the movants) would likely benefit from the appointment of an examiner, such request was not deemed to satisfy the “interests” test.¹²⁵ In deciding whether to appoint an examiner, courts have also considered the overall financial benefit that an examiner could bring to the estate.¹²⁶ Allegations of corporate fraud and misconduct by a debtor’s insiders or affiliates are often cited as reasons for appointing an examiner so that the examiner may investigate such allegations.¹²⁷

It is noteworthy that although the language in section 1104 is not explicit, some courts and scholars have stated that the “interests” test for the appointment of examiners is the same “interests” test that is applied to the appointment of trustees: the “best interests” test.¹²⁸ This reasoning may be based on the fact that the “interests” test in section 1104(a) respecting trustee appointments and section 1104(c) respecting examiner appointments is substantially identical;¹²⁹ indeed, the statute does not explicitly provide for a “best interests” test.¹³⁰

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

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

125 See, e.g., *In re* Loral Space & Commc’ns Ltd., 313 B.R. 577, 583–84 (Bankr. S.D.N.Y. 2004), *rev’d and remanded on other grounds*, 2004 WL 2979785 (S.D.N.Y. Dec. 23, 2004) (“The Ad Hoc Committee’s motion clearly fails the ‘in the interests of the estate’ test of section 1104(c)(1) of the Bankruptcy Code. First, under section 1104(c)(1) the appointment of an examiner must be in the interests of the estate in general. Here, however, the appointment of an examiner would, at best for the shareholders, advance only their interests in opposition to the Debtors’ plan.”). On appeal, the district court reversed and remanded to the bankruptcy court, mandating the appointment of an examiner but solely on the ground that “[o]n its face, Section 1104(c)(2) mandates the appointment of an examiner where a party in interest moves for an examiner and the debtor has \$5,000,000 of qualifying debt.” *In re* Loral Space & Commc’ns Ltd., 2004 WL 2979785, at *4 (S.D.N.Y. Dec. 23, 2004).

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

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

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

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

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

If appointed, the primary duty of an examiner under current law is to (i) “conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor or by current or former management of the debtor”¹³¹ and (ii) “(A) file a statement of any investigation conducted . . . including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and (B) transmit a copy or a summary of any such statement to any unsecured creditors’ committee or equity security holders’ committee, to any indenture trustee, and to such other entity as the court designates.”¹³²

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

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

Notwithstanding the potential benefit to the estate, some observers argue that an examiner simply adds another layer of cost and delay to the process and that the debtor in possession or unsecured creditors’ committee can serve the same function.¹³⁵ The primary response to this potential critique is that an examiner comes to the process with a special, independent, and neutral role, which no other party can claim. The principle that the proper role of an examiner is that of a disinterested, nonadversarial officer of the court has been so widely accepted that it can hardly be doubted.¹³⁶

¹³¹ 11 U.S.C. § 1104(c).

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

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

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

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

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

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

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

The Estate Neutral: Recommendations and Findings

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

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

¹³⁸ See, e.g., Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re W.R. Grace & Co.*), 285 B.R. 148, 156–57 (Bankr. D. Del. 2002) (denying debtor's motion to appoint examiner with expanded powers or trustee with limited purpose to prosecute fraudulent transfer claims because "the basic job of an examiner is to examine, not to act as a protagonist in the proceedings" and "[t]here is no such entity as a limited purpose trustee under the [Bankruptcy] Code"); *Kovalesky v. Carpenter*, 1997 WL 630144, at *3 (S.D.N.Y. Oct. 9, 1997) ("Examiners . . . play a chiefly information-seeking role and, like the court itself, must remain a neutral party in the bankruptcy process."); *In re Interco Inc.*, 127 B.R. 633, 638 (Bankr. E.D. Mo. 1991) ("[T]he examiner's role is by its nature disinterested and non-adversarial. There is no doubt that the examiner is a neutral party in a bankruptcy case."); *In re Baldwin United Corp.*, 46 B.R. 314, 316–17 (Bankr. S.D. Ohio 1985) ("[W]e never contemplated, nor in our opinion does the Bankruptcy Code contemplate, that the examiner act as a conduit of information to fuel the litigation fires of third-party litigants."); *In re Hamiel & Sons Inc.*, 20 B.R. 830, 832 (Bankr. S.D. Ohio 1982) (an examiner "constitutes a court fiduciary and is amenable to no other purpose or interested party"). But see S. Rep. No. 989, 95th Cong. 2d Sess. 116 (1978), reprinted in 1978 U.S.C.C.A.N. 5787 ("The [bankruptcy] court is authorized to give the examiner additional duties as circumstances warrant."); *In re Mirant Corp.*, 2004 WL 2983945, at *2–3 (Bankr. N.D. Sept. 1, 2004) (examiner authorized to monitor and mediate plan negotiations); *In re Pub. Serv. Co. of N.H.*, 99 B.R. 177 (Bankr. D.N.H. 1989) (examiner authorized to mediate negotiations related to chapter 11 plan); *In re UNR Indus., Inc.*, 72 B.R. 789 (Bankr. N.D. Ill. 1987) (examiner appointed to negotiate chapter 11 plan and facilitate resolution of substantive differences).

compromise. As further explained below, the Commission determined that the concept of an estate neutral should replace examiners under the Bankruptcy Code.

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

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

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

The Commission also considered the potential cost savings that an estate neutral may generate in cases when the parties are at an impasse in negotiations or need an independent investigation to facilitate resolution of particular matters. The Commissioners discussed how courts should balance the costs associated with an estate neutral with the potential efficiencies created by the appointment. The Commissioners also observed that, even under this cost-benefit analysis, the circumstances of the case could warrant the appointment of more than one estate neutral to perform different functions

in the case, but the Commissioners believed that this should be the exception rather than the rule. The Commissioners did not want to create roles for third parties in the case or impose additional costs on the process if unnecessary or if the benefits would be marginal at best. Accordingly, the Commission recommended a presumption against the appointment of more than one estate neutral in any given case, which could be rebutted by evidence that the circumstances of the case and a cost-benefit analysis support the additional appointment. The Commission also concluded that, with the elimination of the mandatory appointment provision, if the circumstances of the case warrant the appointment of an estate neutral, the potential benefit of the estate neutral to the estate would likely outweigh any additional costs to the estate. The Commission ultimately voted to provide more flexibility to the court and the parties in using estate neutrals, as set forth in the principles above, and to recommend use of estate neutrals in lieu of examiners.

The Commissioners discussed the related concept of a statutory reorganization executive, which would be similar in some ways to an examiner with expanded powers but different in several key respects. For example, a statutory reorganization executive would likely be suggested and supported by the debtor and could operate the debtor's business, work directly with the parties to help facilitate a plan, and function more as an insider of the debtor (akin to a chief restructuring officer).¹³⁹ The Commissioners explored the contours of this new fiduciary, which some Commissioners believed would need to be accountable to the debtor's board of directors and subject to applicable state fiduciary duty laws. The Commissioners who supported the concept of a statutory reorganization executive viewed it as a private solution that parties would use more readily than seeking the appointment of a trustee or examiner. The Commissioners who opposed the concept of a statutory reorganization executive voiced concerns similar to those noted above respecting an examiner with expanded powers and viewed the appointment of a trustee as the better alternative. Ultimately, the Commission voted against the concept of a statutorily recognized reorganization executive, but did consider the potential value of such a position in considering and developing the parameters of the role of an estate neutral.

4. Statutory Committees

Recommended Principles:

- Except as provided in the principles for small and medium-sized enterprise cases, the appointment of an unsecured creditors' committee should remain mandatory as provided under section 1102(a) of the Bankruptcy Code unless the court orders otherwise for cause. The term "cause" should include that such an appointment would not be in the best interests of the estate or that the interests of general unsecured creditors do not need representation in the particular case because, for

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

example, they will not receive any distributions in the case or their claims will be paid in full.

- The court *sua sponte*, the U.S. Trustee, or a party in interest should be able to initiate a hearing to determine whether the appointment or continuation of an unsecured creditors' committee would be in the best interests of the estate.
- The U.S. Trustee should continue to retain discretion to appoint a committee of equity security holders, more than one committee of unsecured creditors, or a single statutory committee for multiple affiliated debtors. Accordingly, no change to existing law is suggested on this point.

Statutory Committees: Background

The concept of a committee of creditors formed to monitor the debtor and its reorganization efforts stems from the equity receiverships of the late 1800s and Chapter XI of the Bankruptcy Act.¹⁴⁰ The unsecured creditors' committees that were formed in the equity receivership context were criticized for their close and arguably collusive relationships with the debtor.¹⁴¹ Nevertheless, Congress recognized the value in the committee structure, both in terms of their oversight functions and the dynamic tension that their presence and participation adds to restructuring negotiations.¹⁴² Congress thus maintained some form of committees in the Bankruptcy Act and extended that structure to all business reorganizations under chapter 11 of the Bankruptcy Code.

Section 1102 of the Bankruptcy Code provides that “the United States trustee shall appoint a committee of creditors holding unsecured claims”¹⁴³ that “shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee. . . .”¹⁴⁴ The legislative history of section 1102 suggests that Congress intended to give unsecured creditors a stronger voice in the reorganization process.¹⁴⁵ The unsecured creditors'

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

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

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

¹⁴³ 11 U.S.C. § 1102(a)(1).

¹⁴⁴ *Id.* § 1102(b)(1).

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

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committee has been viewed not only as necessary to protect the interests of the many unsecured creditors unable to participate directly in the process, but also to further monitor the actions of the debtor in possession during the chapter 11 case. It can play “many roles” in a chapter 11 case.¹⁴⁶

The appointment of a committee of unsecured creditors is mandatory in chapter 11 cases, but cases do proceed without committees in certain circumstances. For example, the U.S. Trustee can only constitute a committee if a sufficient number of creditors are willing to serve on the committee.¹⁴⁷ An individual creditor will often engage in a cost-benefit analysis to decide whether to serve on the unsecured creditors’ committee. As a committee member, a creditor owes certain fiduciary duties, and its service consumes time and effort that could otherwise be devoted to the creditor’s own business. Consequently, unsecured creditors may decide, particularly in smaller chapter 11 cases, that the economics do not favor service on a committee of unsecured creditors.

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

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

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

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

148 11 U.S.C. § 1102(a)(1).

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

150 *Id.*

151 *Id.*

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

153 11 U.S.C. § 1102(a)(2), (4).

creditors' committee in such cases under certain circumstances, and courts have generally approved this approach.¹⁵⁴

Once appointed, the unsecured creditors' committee serves in a fiduciary capacity with respect to the other unsecured creditors it represents and is granted certain powers under section 1103 of the Bankruptcy Code.¹⁵⁵ The committee may, among other things, meet with the debtor, investigate the debtor's affairs, participate in the plan formulation process, and request the appointment of a trustee or examiner.¹⁵⁶ The committee may also retain professionals to represent it in the chapter 11 case.¹⁵⁷ The expenses of committee members and the fees and expenses of the committee's counsel and other professionals are generally paid from the estate.

Statutory Committees: Recommendations and Findings

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

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

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

155 See, e.g., *In re Fas Mart Convenience Stores, Inc.*, 265 B.R. 427, 432 (Bankr. E.D. Va. 2001) ("Members of the committee also have another duty — a fiduciary duty to all creditors represented by the committee."); *In re Firstplus Fin., Inc.*, 254 B.R. 888, 894 (Bankr. N.D. Tex. 2000) ("In a Chapter 11 case, an Unsecured Creditors' Committee is appointed by the Office of the United States Trustee and owes a fiduciary duty to act on behalf of all unsecured creditors.").

156 11 U.S.C. § 1103(c).

157 *Id.* § 1103(a).

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

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After extensive deliberation, the Commission recommended retaining the mandatory appointment of a committee of unsecured creditors in all cases, except small and medium-sized enterprise cases (addressed in a subsequent section).¹⁵⁹ The Commissioners found value in the traditional “watchdog” function of the committee, not only as a check on the debtor in possession, but also as a check on other stakeholders and the allocation of the estate’s value among stakeholders. Indeed, unlike secured or administrative creditors — whose claims must be paid in order to confirm a plan — the Bankruptcy Code does not mandate any minimum return for general unsecured creditors (other than that they receive more than they would in a chapter 7 liquidation). The unsecured creditors’ committee is the primary statutory protection for general unsecured creditors. Nevertheless, the Commission did find merit in the argument that a committee should not be appointed if its constituents have no need for representation in the case (*i.e.*, their claims are out of the money or are being paid in full). The Commission agreed that this standard should be part of a “for cause” standard that would, if established by evidence at the hearing, allow the court to direct the U.S. Trustee not to appoint, or to disband, an unsecured creditors’ committee.

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

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

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

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

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

¹⁶² For example, section 1122(b) of the Bankruptcy Code permits a debtor use an administrative convenience class to pay trade creditors in full even when the plan is not able to fully repay claims of other unsecured creditors that will be discharged. See Brad B. Erens & Timothy W. Hoffmann, *The Triumph of the Trade Creditor in Chapter 11 Reorganizations*, J. Bankr. L., Jan. 2013, at

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

5. Estate Fiduciaries

Recommended Principles:

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

Estate Fiduciaries: Background

In *Barton v. Barbour*, the U.S. Supreme Court confirmed the “general rule that before suit is brought against a receiver leave of the court by which he was appointed must be obtained.”¹⁶⁴ The Supreme Court also held that this general rule applies equally to suits seeking equitable relief (e.g., to recover specific property) and damages (i.e., money).¹⁶⁵ Courts have generally extended the *Barton* doctrine to trustees¹⁶⁶ in bankruptcy and other officers appointed by the court. “As the Sixth Circuit has observed, under the *Barton* doctrine, ‘court appointed officers who represent the estate are the functional equivalent of a trustee.’”¹⁶⁷ Accordingly, some courts have determined that postconfirmation trustees and members of the unsecured creditors’ committee are also deemed officers appointed by the court and thus covered by the *Barton* doctrine.¹⁶⁸

26 (“[D]ebtors sometimes have promulgated plans with very large administrative convenience claim caps for trade claims. Any claim up to that cap would be paid in full. Even claims above such cap could voluntarily elect to reduce their claims to the cap and, to that extent, often receive close to full payment. In this manner, debtors have been able to pay trade creditors under a plan a higher percentage on account of their claims than, for instance, similarly situated unsecured bondholders.”).

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

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

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

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

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

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

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

Estate Fiduciaries: Recommendations and Findings

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

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

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

The Commissioners believed that this clarification would (i) allow any trustee, estate neutral, and statutory committee and its members to perform their fiduciary duties with confidence and focus,¹⁷³ and (ii) eliminate unnecessary litigation concerning the application of the *Barton* doctrine and whether the court in which a litigant files the action has subject matter jurisdiction over the dispute.¹⁷⁴ For similar reasons, the Commission voted to extend the *Barton* doctrine to any professionals retained by any trustee, estate neutral, or statutory committee or its members to the extent that the litigation involves the professionals’ representation of such party in a fiduciary capacity.

The Commissioners recognized that this recommended principle could also apply to cases filed under other chapters of the Bankruptcy Code. Although the Commission did not study bankruptcy

¹⁶⁹ 28 U.S.C. § 959(a).

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

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

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

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

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

cases under these other chapters, it believed that the *Barton* doctrine should apply to all cases and proceedings under the Bankruptcy Code.

6. Valuation Information Packages

Recommended Principles:

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

Valuation Information Packages: Background

A debtor is required to file a variety of forms, schedules, and other information upon commencement of its chapter 11 case or shortly thereafter. The Bankruptcy Code generally gives debtors a short grace period after the petition date to file the required forms,¹⁷⁵ and debtors typically can request additional time for the filing of certain materials.¹⁷⁶ Nevertheless, a debtor’s timely and full disclosure is a necessary component of the chapter 11 process. Without this basic information, the court, the U.S. Trustee, and parties in interest cannot assess the debtor’s reorganization efforts and make meaningful decisions in the case.

¹⁷⁵ Fed. R. Bankr. P. 1007(c), (d).

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

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

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

Valuation Information Packages: Recommendations and Findings

The Commissioners analyzed the potential benefits of the requirement that debtors provide additional and earlier disclosures of meaningful financial data, particularly data that may assist parties in interest to assess valuation issues.¹⁷⁹ Among other potential benefits, such disclosures may help reduce information asymmetries and allow parties to make better-informed decisions regarding the impact of the debtor's proposed exit strategy on their recoveries in the case. Such disclosures could

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

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

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

also facilitate more meaningful discussions regarding the debtor's viable reorganization options earlier in the chapter 11 case.

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

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

To mitigate some of the valid concerns raised by the Commissioners regarding the debtor's confidentiality and strategy, the Commission agreed that the disclosure obligations should be subject to appropriate provisions regarding confidentiality and fiduciary outs. In addition, the debtor should be required to file only a list of the information included in its VIP if the trustee¹⁸⁰ or a party in interest requests certain relief under the Bankruptcy Code. A party in interest would then be able to request copies of such disclosure documents. Finally, the Commission concluded that the additional disclosure information should not be filed with the U.S. Trustee as a matter of course to alleviate a debtor's confidentiality concerns.¹⁸¹ With these modifications, the Commission approved the recommended VIP as outlined in the principles above.

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

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

7. Professionals and Compensation Issues

Recommended Principles:

- The debtor's professionals should be clearly identified as either working on matters relating to the chapter 11 case ("chapter 11 professionals") or on matters unrelated to the chapter 11 case ("nonbankruptcy professionals").
- The Bankruptcy Code should define a "*nonbankruptcy professional*" as an individual or firm of lawyers, financial advisors, accountants, consultants, or other professionals retained by the debtor prior to or after the petition date working exclusively on business or legal matters that arise in, or relate primarily to, the day-to-day operations of the debtor's business and that could not have a material effect on the chapter 11 case.
- Only chapter 11 professionals should be subject to sections 327 and 330.
- The debtor should file with the court a list of its nonbankruptcy professionals with its chapter 11 petition and then subsequently on a quarterly basis. That filing should include the name of each professional and a general description of the work being performed by that professional. The court *sua sponte*, the U.S. Trustee, or a party in interest should be able to object to the classification of a professional as a nonbankruptcy professional. If the court, after notice and a hearing, sustains such objection, the professional should be subject to sections 327 and 330 only on a prospective basis. This principle does not obviate the trustee's need to otherwise comply with the U.S. Trustee's requirements for quarterly operating reports.
- To the extent professionals representing *ad hoc* committees, parties to any agreement or settlement, or secured creditors in the chapter 11 case would be paid their fees and expenses directly or indirectly (e.g., contractual provisions with junior creditors) from the estate under the Bankruptcy Code (either through a substantial contribution motion, the creditors' proof of claim, the chapter 11 plan, or other order of the court), the approval and payment of their fees and expenses should be subject to the reasonableness standards set forth in section 330(a).
- Professionals retained by the debtor in possession or any statutory committee should not be considered fiduciaries of the estate. Rather, those professionals' duties should run to their respective clients and be governed by applicable nonbankruptcy law.
- A court should be permitted to authorize a trustee or an estate neutral to act not only as an attorney or an accountant for the estate, but also as a professional service provider for the estate to the extent that such authorization is in the best interests of the estate. The employment of a trustee or an estate neutral to act as a professional service provider should remain subject to appropriate limitations and restrictions to avoid self-dealing or other action that is improper or not in the best interests of the estate. Section 327(d) should be amended accordingly.

Professionals and Compensation Issues: Background

Nonbankruptcy Professionals

A debtor in possession¹⁸² generally must seek court approval to retain professionals to assist it with the chapter 11 case. Specifically, section 327(a) of the Bankruptcy Code provides: “the trustee, with the court’s approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee’s duties under this title.”¹⁸³ The fees and expenses of professionals retained under section 327 are subject to court approval under section 330 of the Bankruptcy Code.¹⁸⁴

The Bankruptcy Code does not define “professional persons” or specifically address the debtor in possession’s ability to hire and pay professionals to assist with nonbankruptcy matters that arise in the operation of the debtor’s business. The one exception to this statement involves lawyers retained for a special purpose. Section 327(e) provides: “The trustee, with the court’s approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interests of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed.”¹⁸⁵ In general, courts tend to define “professional” in one of two ways, focusing on whether the entity either (i) plays a central role in the administration of the estate, or (ii) is allowed to exercise judgment and autonomy in matters concerning the administration of the estate.¹⁸⁶ Accordingly, debtors in possession frequently seek clarification from the court concerning the scope of “professionals” retained by the debtor in possession and its ability to pay these professionals in the ordinary course of business.¹⁸⁷

The disinterestedness standard generally requires that the professional not be a creditor or, within the two years before the petition date, a director, officer, or employee of the debtor. It also mandates that the professional not hold “an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor.”¹⁸⁸ Some courts interpret disinterestedness strictly, disqualifying any professional holding actual or potential conflicts of interest with the debtor.¹⁸⁹ Other courts take

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

183 11 U.S.C. § 327(a).

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

185 11 U.S.C. § 327(e).

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

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

188 *Id.* § 101(14)(E).

189 See, e.g., *Dye v. Brown (In re AFI Holding, Inc.)*, 530 F.3d 832, 838 (9th Cir. 2008) (“[B]ankruptcy court did not abuse its discretion in concluding removal was proper due to the Trustee’s past affiliations with insiders that created a potential for a materially adverse effect on the estate and an appearance of impropriety resulting in ongoing disharmony in the estate’s administration.”); *In re Marvel Entm’t Grp., Inc.*, 140 F.3d 463, 476 (3d Cir. 1998) (“(1) Section 327(a), as well as § 327(c),

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a more limited view and only disqualify the professional if it holds an interest that is “materially adverse” to the estate.¹⁹⁰

Under the current law, debtors in possession will often seek court approval of procedures for retaining and compensating “ordinary course professionals” during the pendency of the chapter 11 case. These procedures typically require the debtor to identify the specific or general types of professionals or service providers covered by the motion and to establish a cap that limits the amounts that can be paid to these entities (usually on a quarterly basis) during the case. Such ordinary course professionals may be required to file a verified statement under Bankruptcy Rule 2014(a), although debtors generally agree to submit quarterly summaries of the fees paid to these professionals. Courts routinely approve motions related to ordinary course professionals to enable a debtor to continue its operations during the chapter 11 case as efficiently as possible.

Other Professionals

The ability of debtors in possession, trustees or other estate representatives, and statutory committees to retain professionals is subject to approval by the court under section 327 of the Bankruptcy Code; the court thereafter reviews and scrutinizes the compensation requests of professionals under section 330. Other parties in the chapter 11 case may also seek reimbursement for, or payment of, their professionals’ fees and expenses from estate funds. These parties include secured creditors, creditors who are parties to an agreement or settlement with the debtor or the trustee, parties to intercreditor agreements, and *ad hoc* committees.¹⁹¹ In some instances, such as with *ad hoc* committees, a party may seek payment for its professionals under section 503(b)(3)(D) of the Bankruptcy Code, which permits the payment of the reasonable fees and expenses of “a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title, in making a substantial contribution in a case

imposes a *per se* disqualification as trustee’s counsel of any attorney who has an actual conflict of interest; (2) the district court may within its discretion — pursuant to § 327(a) and consistent with § 327(c) — disqualify an attorney who has a potential conflict of interest and (3) the district court may not disqualify an attorney on the appearance of conflict alone.”); *In re Martin*, 817 F.2d 175, 182 (1st Cir. 1987) (“The question is not necessarily whether a conflict exists — although an actual conflict of any degree of seriousness will obviously present a towering obstacle — but whether a potential conflict, or the perception of one, renders the lawyer’s interest materially adverse to the estate or the creditors.”) (citation omitted); *In re Lease-A-Fleet, Inc.*, 1992 U.S. Dist. LEXIS 407, at *2 (E.D. Pa. Jan. 15, 1992) (“I reject [the] argument that § 327(e) requires disqualification whenever there is a potential conflict. While some courts hold that simultaneous representation of the debtor and its guarantors is prohibited under § 327(e), such is clearly not the rule in this Circuit.”) (citing *In re G&H Steel Service, Inc.*, 76 B.R. 508, 510 (Bankr. E.D. Pa. 1987)).

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

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

under chapter 9 or 11 of this title.”¹⁹² In other instances, the operative loan documents, intercreditor agreement, or other agreement may provide for such payment.

Courts generally require a party making a request under section 503(b)(3)(D) to prove “extraordinary efforts” to benefit the estate.¹⁹³ Some courts also require a showing that the party in fact intended to benefit the estate through such efforts.¹⁹⁴ Moreover, if a party establishes a substantial contribution claim under section 503(b)(3)(D), it may also be entitled to reasonable compensation “for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph (A), (B), (C), (D), or (E) of paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant.”¹⁹⁵

Trustee and Estate Neutral Issues

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

In addition, a chapter 11 trustee is subject to the same compensation provisions applicable to chapter 7 trustees under sections 326(a) and 330. In a chapter 7 liquidation, the mechanics of section 326(a) work well¹⁹⁸; a trustee is compensated based on a percentage of the moneys distributed to parties in interest other than the debtor. In a chapter 11 case, however, the limitations of section 326(a) might serve as a disincentive for a trustee to seek recoveries that would result in a return of funds to equity. In fact, some courts have denied compensation to chapter 11 trustees under section 326(a) when distributions are made to the debtor, or property or value other than money is distributed in the case.¹⁹⁹

¹⁹² 11 U.S.C. § 503(b)(3)(D).

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

¹⁹⁴ See, e.g., *In re Lister*, 846 F.2d 55, 57 (10th Cir. 1988) (“Administrative expenses incurred prior to the filing of a bankruptcy petition are compensable under 11 U.S.C. § 503(b)(3)(D), if those expenses are incurred in efforts which were intended to benefit, and which did directly benefit, the bankruptcy estate.”); *In re Alert Holdings Inc.*, 157 B.R. 753, 758 (Bankr. S.D.N.Y. 1993) (court held that “[n]either [the creditor’s] asserted help in forming the *ad hoc* committee, nor his participation in the multidistrict litigation demonstrates an intent to substantially benefit the debtors’ estates, and any benefit that may have otherwise enured to the estates can be considered unintentional and incidental.”); *In re 9085 E. Mineral Office Bldg., Ltd.*, 119 B.R. 246, 251–52 (Bankr. D. Colo. 1990) (“[T]his Court cannot find that [the creditor’s] efforts were in no way intended to confer a benefit upon the estate as a whole.”).

¹⁹⁵ 11 U.S.C. § 503(b)(4).

¹⁹⁶ 11 U.S.C. § 327(a).

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

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

¹⁹⁹ See, e.g., *id.* at 237 (declining to follow “bankruptcy courts [that] have interpreted the section to include disbursements other than money within the calculation of a trustee’s maximum compensation”) (collecting cases). In addition, some courts hold that

Professionals and Compensation Issues: Recommendations and Findings*Nonbankruptcy Professionals*

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

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

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

a credit bid by a secured creditor is not money for purposes of section 326(a). *See, e.g., In re Lan Assocs. XI, L.P.*, 192 F.3d 109, 116 (3d Cir. 1999); *U.S. Trustee v. Tamm (In re Hokulani Square, Inc.)*, 460 B.R. 763, 777–78 (B.A.P. 9th Cir. 2011).

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

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

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

Other Professionals

The Commission reviewed similar issues and concerns with respect to professional compensation paid by the estate for services provided to secured creditors; creditors who are parties to settlements or agreements with the debtor, trustee, estate or other parties in the case (*e.g.*, intercreditor agreements); and *ad hoc* committees. The Commissioners recognized that the services of these professionals could add value to a chapter 11 case. Moreover, the payment of the attendant professionals' fees and expenses is often part of the underlying bargain and is authorized by an order of the court in connection with a substantial contribution motion, a motion to approve the settlement or agreement under the Bankruptcy Code, the creditor's proof of claim, or the chapter 11 plan. Nevertheless, some of the Commissioners expressed concern that parties often stipulate to the reasonableness of professionals' fees and expenses, such that they are no longer subject to any meaningful review by the court or other parties in interest.

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

Trustee and Estate Neutral Issues

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

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

The Commissioners also discussed the compensation structure of section 326(a) and whether it provided proper incentives to trustees to maximize the value of the estate. As explained above, section 326(a) compensates trustees based on a percentage of the amount of moneys distributed or turned over to parties in interest in the case other than the debtor. Some Commissioners suggested modifying section 326(a) to exclude only distributions to "chapter 7 debtors and individual chapter 11 debtors" from the compensation calculation, recognizing the different focus of case administration in chapter 11 cases involving business debtors. These Commissioners noted that the

exclusion of distributions to the debtor from the compensation calculation could encourage trustees to administer the estate in a manner that restricts recoveries or liquidates assets for the benefit of parties in interest other than the debtor in order to maximize the trustee's compensation. Other Commissioners suggested that such conduct likely would be a violation of the trustee's fiduciary duties, which should be a sufficient deterrent of such conduct. The Commissioners debated these points, focusing on the alignment of section 326(a) with a trustee's fiduciary duties to better serve the estate. The Commission ultimately was not able to reach a consensus on the issue. Nevertheless, several Commissioners believed that certain modifications could add value to cases and eliminate ambiguities in the application of section 326 to chapter 11 business cases.²⁰⁰

8. Costs in Chapter 11 Cases

Recommended Principles:

- The Bankruptcy Code should be clarified to expressly permit professionals retained pursuant to section 327 or 1103 of the Bankruptcy Code to seek the court's approval, at the outset of the engagement or of a particular matter, of alternative fee arrangements in lieu of the traditional hourly billing model. Such alternative fee arrangements could include the following: fixed fees, flat fees, task-specific fees, and contingent fees. Courts should assess the reasonableness of, and the potential benefits to the estate from, a professional's proposed alternative fee arrangement at the time that the court is evaluating the professional's original retention application or at the outset of the matter or engagement that will be subject to the proposed alternative fee arrangement. The professional seeking an alternative fee arrangement should bear the burden of proving by a preponderance of the evidence that the arrangement is reasonable, has been thoroughly reviewed with the client, and is reasonably likely to be beneficial to the estate. Section 328 should be clarified to incorporate this approval standard.
- Once a court has approved an alternative fee arrangement, it should not alter the approved arrangement once the matter or engagement has terminated unless, in accordance with section 328 as it currently provides, the "terms and conditions [of the arrangement] prove to [be] improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." Courts should not review alternative fee arrangements under the lodestar method, which is applicable to the hourly billing model.
- Congress should amend sections 328 and 330 to clarify that alternative fee arrangements based in whole or in part on non-hourly billing models are permitted and subject to review solely under section 328, in accordance with the changes proposed in these principles.

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

Costs in Chapter 11 Cases: Background

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

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

The estate's administrative outlay for professionals' fees is often the focal point of debates concerning the costs of chapter 11.²⁰⁵ Headlines such as *Extra! Extra! Tribune Fees Top \$150 Million*,²⁰⁶ and *American Airlines Bankruptcy Advisors Seek \$400 Million in Fees, Expenses*²⁰⁷ catch the attention of

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

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

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

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

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

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

(B) reimbursement for actual, necessary expenses.

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

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

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

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

policymakers and the public alike, but a look behind the numbers cited in these headlines may reveal a different story.²⁰⁸ In fact, empirical studies show that the total amount in professionals' fees in a chapter 11 case is generally a modest percentage of the debtor's assets, revenues, and distributions to creditors.²⁰⁹ But these studies do not change the perception — whether or not accurate — that every dollar an estate pays in chapter 11 costs is one less dollar available to pay creditors.²¹⁰ As pointed out by one professor who has studied professionals' fees extensively, this perception necessarily ignores the value that professionals add to the estate during the pendency of a chapter 11 case for the benefit of all parties in interest.²¹¹

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

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

209 Professor Lubben's study revealed that across all bankruptcy cases, and even across large chapter 11 cases specifically, professionals' fees totaled 4.0 percent to 4.5 percent of the sum of the debtor's assets and debts. Lubben, *Corporate Reorganization & Professional Fees*, *supra* note 205, at 103. See also Greenspan, *supra* note 204. These results are consistent with earlier fee studies. Based on a 2004 study of large chapter 11 reorganization cases filed from 1980 through April 2003, Professors LoPucki and Doherty found that some of the largest debtor cases expended less than 3 percent of their total assets to pay for professionals' fees. Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Empirical Legal Stud. 111, 140 (2004) (“For a group of 48 firms with assets ranging from about \$65 million to \$7.5 billion, and averaging \$881 million, we found that total fees and expenses were 1.4 percent of total assets reported in the court file at the beginning of the bankruptcy case, and that firms expended, on average, 2.2 percent of assets on professional fees (1.9 percent after the removal of a single outlier).”). Professors LoPucki and Doherty explained that economies of scale were at play in large chapter 11 cases, such that the larger the debtor, the lower the ratio of restructuring fees and expenses the debtor incurred relative to its assets. *Id.* at 126. Earlier, Professor Baird also observed that the direct costs of bankruptcy for large, publicly traded companies was relatively small, between 0.9 percent and 7.0 percent, and an average of 2.8 percent, of the book value of the assets before the filing of the bankruptcy petition, which was comparable to or less than the costs of an initial public offering, private placement, or leveraged buyout. Douglas G. Baird, *The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms*, Coase-Sandor Inst. for L. & Econ. Working Paper No. 43, 1997, at 11–12, available at http://chicagounbound.uchicago.edu/law_and_economics/527/.

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

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

212 Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, 5 J. Bus. & Tech. L. 263, 270–271 & n. 28 (2010), available at <http://digitalcommons.law.umaryland.edu/jbtl/vol5/iss2/5> (summarizing published criticisms of professionals' fees in chapter 11 context).

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

214 The new fee guidelines became effective for cases filed on or after November 1, 2013. Appendix B — Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed Under 11 U.S.C. § 330 by Attorneys in Larger Chapter 11 Cases, 78 Fed. Reg. 36,248, 36,249 (June 17, 2013), available at http://www.justice.gov/ust/eo/rules_regulations/guidelines/docs/Fee_Guidelines.pdf [hereinafter *UST Fee Guidelines*]. “Generally, the final guidelines provide for a showing that rates charged

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

Additionally, the increasing cost of chapter 11 has had a significant impact on the perceived ability — and perhaps actual ability — of small and middle-market companies seeking restructuring options to invoke chapter 11.²¹⁷ One commentator observed that, based on a small sampling of cases filed in 2010 in the Southern District of New York, “professional fees for the middle-market Chapter 11 cases typically approached or exceeded \$1 million.”²¹⁸ This commentator suggested that high professionals’ fees, among other factors,²¹⁹ have encouraged lawyers representing middle-market companies to pursue alternatives to traditional chapter 11 reorganization, such as section 363 asset sales on an expedited basis, followed by a liquidating plan, or to invoke alternatives under state law, including general assignments for the benefit of creditors and composition agreements to restructure debt.²²⁰ Although this particular study was limited in size and geographic area, the commentator’s findings mirror the testimony and anecdotal evidence presented to the Commission during its study process.²²¹

reflect market rates outside of bankruptcy; the use of budgets and staffing plans; the disclosure of rate increases that occur during the representation; the submission of billing records in an open, searchable electronic format; and the use of fee examiners and ‘efficiency’ counsel.” *Statement of Clifford J. White III, Director, Executive Office for United States Trustees, U.S. Department of Justice, before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of H. Comm. on the Judiciary*, at 10 (Sept. 19, 2014) [hereinafter *White Statement*]. For a one-page summary of the *UST Fee Guidelines* prepared by the U.S. Department of Justice, see Summary of Material Differences from 1996 Guidelines, http://www.justice.gov/ust/eo/rules_regulations/guidelines/docs/One_Page_Summary_AppxB_Guidelines.pdf. See also Marina Fineman, *For Lawyers Only: New Fee Application Guidelines for Attorneys in Large Chapter 11 Cases*, ABI Ethics & Professional Compensation Committee News, Vol. 10, no. 4, available at <http://www.abiworld.org/committees/newsletters/ethics-and-professional-compensation/vol10num4/lawyers.html>.

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

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

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

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

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

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

221 See, e.g., John Haggerty, *Written Statement to the Commission* (Apr. 19, 2013) (“In the last ten years, there has been an increase in the use of out-of-court alternatives . . . because the process is too time consuming and complex, and as a result, too costly.”), available at Commission website, *supra* note 55; The Honorable Dennis Dow, *Written Statement to the Commission* (Apr. 19, 2013)

Costs in Chapter 11 Cases: Recommendations and Findings

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

The Commissioners discussed the various costs associated with filing a chapter 11 case and continuing to conduct business as a debtor in possession.²²² The Commission focused its inquiry on several factors that may contribute to the increasingly high cost of chapter 11. These factors included the prolonged duration²²³ and complexity of a case leading to inefficiencies, the use of strategic or protective litigation in the case by the debtor or other stakeholders, the inherent uncertainty about the outcome of certain processes or legal standards that become the subject of litigation, and the professionals' fees and expenses incurred in connection with the case.²²⁴ The Commission considered various ways to mitigate each of these factors.

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

- The Commission identified, analyzed, and, wherever possible, recommended principles to resolve splits in the case law governing chapter 11 cases to reduce the need for litigation and provide greater certainty about outcomes. To this end, the Commission sought to resolve the following splits, among others:

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

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

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

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

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- o The standard of review applicable to the appointment of a chapter 11 trustee under section 1104;²²⁵
- o The permissibility of cross-collateralization and roll-up provisions in postpetition financing facilities;²²⁶
- o The proper use of the doctrine of necessity in chapter 11 cases;²²⁷
- o The ability of drop shipment transactions to qualify for administrative claim treatment under section 503(b)(9);²²⁸
- o The interplay between the priority afforded to wage claims under section 507(a)(4) and the priority afforded to employee benefit plan claims under section 507(a)(5);²²⁹
- o The ability of a debtor to apply section 1114 to terminate retiree benefit plans that the debtor has the right to unilaterally terminate outside the bankruptcy context;²³⁰
- o The definition of “executory contract” for purposes of section 365;²³¹
- o The effect of rejecting an executory contract or unexpired lease under section 365;²³²
- o The ability of a debtor to assume intellectual property licenses under section 365(c) (*i.e.*, the hypothetical test versus the actual test)²³³ and the treatment of trademark licenses generally;²³⁴
- o The proper calculation of a landlord’s claim against the estate (*i.e.*, the accrual approach versus the billing date approach);²³⁵
- o The application of the safe harbor in section 546(e) to bar fraudulent transfer actions brought under applicable nonbankruptcy law (*i.e.*, state laws including the Uniform Fraudulent Transfer Act or similar statutes as adopted in each state);²³⁶
- o The treatment of ordinary supply contracts as qualified financial contracts subject to the protection of the Bankruptcy Code’s safe harbor provisions;²³⁷
- o The meaning of “for the benefit of the estate” under section 550;²³⁸
- o The fiduciary duties of a debtor (as opposed to a debtor in possession) proposing a chapter 11 plan;²³⁹

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

226 See Section IV.B.2, *Terms of Postpetition Financing*.

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

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

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

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

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

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

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

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

235 See Section V.A.6, *Real Property Leases*.

236 See Section IV.E.1, *Scope of Section 546(e) Safe Harbors*.

237 See Section IV.E.3, *Assumption of Financial Contracts*.

238 See Section V.C.2, *Recoveries Under Section 550*.

239 See Section IV.A.5, *Estate Fiduciaries*.

60 IV. PROPOSED RECOMMENDATIONS: COMMENCING THE CASE

- o The fiduciary duties of professionals paid from the estate;²⁴⁰ and
- o The permissibility of gifting²⁴¹ and nonconsensual third party releases²⁴² in the context of a chapter 11 plan.
- The requirement that a debtor identify and disclose information relevant to valuation issues earlier in the case should provide a more transparent and expedient chapter 11 process for all parties in interest.²⁴³
- The creation of an “estate neutral” offers the court, the debtor, and other parties in interest a tool to more cost-effectively investigate and resolve disputes and other potential barriers to a debtor’s reorganization efforts.²⁴⁴
- The enhanced procedures governing a debtor’s request to modify or terminate a collective bargaining agreement under section 1113 should encourage (i) the debtor to initiate this process earlier in the case and (ii) both the debtor and authorized representatives to undertake meaningful negotiations before moving forward with litigation strategies.²⁴⁵
- A clear set of rules governing a sale of all or substantially all of a debtor’s assets in chapter 11 — with appropriate protections and adequate time to allow the court, the debtor’s stakeholders, and potential bidders to identify and resolve issues relating to the debtor’s proposed exit strategy — should reduce delay, diminish the risk of losing value for the estate, and should simplify and expedite procedures.²⁴⁶
- The ability of a debtor or plan proponent to cram down a chapter 11 plan without the need to have an accepting impaired class of claims should eliminate (i) manipulative, strategic, and tactical maneuvering by the debtor and creditors (*e.g.*, class construction, acquiring blocking positions within classes, etc.), and (ii) litigation concerning classification and impairment issues and focus the confirmation process on the merits of the plan.²⁴⁷
- Similarly, the refinement of the absolute priority rule to permit distributions to junior creditors when supported by the reorganization value and redemption option value in the case,²⁴⁸ as well as the codification of the new value corollary,²⁴⁹ should reduce litigation and expedite the confirmation process.
- Specific guidelines tailored for small and medium-sized enterprises should streamline and simplify the chapter 11 process for these kinds of debtors and eliminate litigation and expense concerning the new value corollary, the absolute priority rule, and the section 1129(a)(10) issues that are prevalent in these cases.²⁵⁰

²⁴⁰ See Section IV.A.7, *Professionals and Compensation Issues*.

²⁴¹ See Section VI.C.6, *Class-Skipping and Intra-Class Discriminating Distributions*.

²⁴² See Section VI.E.3, *Third Party Releases*.

²⁴³ See Section V.F, *General Valuation Standards*.

²⁴⁴ See Section IV.A.3, *The Estate Neutral*.

²⁴⁵ See Section V.D.1, *Collective Bargaining Agreements Under Section 1113*.

²⁴⁶ See Section V.B, *Use, Sale, or Lease of Property of the Estate*.

²⁴⁷ See Section VI.F.1, *Class Acceptance Generally and for Cramdown Purposes*.

²⁴⁸ See Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

²⁴⁹ See Section VI.C.2, *New Value Corollary*.

²⁵⁰ See Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

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

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

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

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

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

In rejecting the pre-Bankruptcy Code system, the Commissioners acknowledged that any reforms to professionals' fees in bankruptcy needed to address the criticism that a market does not exist to control or monitor such fees. Indeed, some commentators suggest that bankruptcy professionals set the standards for fees of professionals in other transactional disciplines. Some Commissioners refuted this criticism, noting that the rates of bankruptcy professionals are in fact determined by the market and must be comparable to the rates that such professionals charge clients outside the bankruptcy context.²⁵³ The Commissioners also observed that the criticism may not apply

251 Wilbur Ross, *Written Statement to the Commission* (Apr. 19, 2013), available at Commission website, *supra* note 55.

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

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

to all bankruptcy professionals, but may be most applicable in the larger chapter 11 cases. Many Commissioners highlighted that the amount of fees and expenses ultimately charged by bankruptcy professionals is driven largely by the complexity of the chapter 11 case and, perhaps more importantly, by the litigious and contentious posture of a case.²⁵⁴ Regardless, the Commissioners believed that all criticisms of, and potential issues with, the current treatment of bankruptcy professionals' fees had to be considered in studying any reforms, which many Commissioners believed should focus on aligning incentives with case efficiency.

The Commission reviewed several large chapter 11 cases in which professionals' fees and expenses garnered media attention, such as the *American Airlines* and *Tribune Co.* cases, as well as *City of Detroit*, even though it is a chapter 9 case.²⁵⁵ In these cases, either the complexity (in the case of *American Airlines*)²⁵⁶ or the novelty (in the case of *City of Detroit*)²⁵⁷ of the issues presented and the litigation initiated by stakeholders to protect or pursue their interests in the case (in the case of *Tribune*),²⁵⁸ or some combination of these factors, contributed to the relatively large amount of professionals' fees and expenses that were incurred in these particular chapter 11 cases.²⁵⁹ The Commissioners debated whether the Bankruptcy Code could or should scrutinize more closely the conduct of clients and professionals in these circumstances to try to regulate professionals' fees. Such *ex post* oversight by the court, particularly with respect to what actions lawyers should or should not have taken on behalf of their clients, could raise ethical issues for lawyers in chapter 11 cases.²⁶⁰ Indeed, lawyers generally are required to defer to their clients in service of their clients' lawful objectives.²⁶¹ Moreover, professionals are already subject to the "reasonable and necessary"

²⁵⁴ See *supra* note 224.

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

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

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

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

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

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

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

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standard of review under Bankruptcy Code section 330 that assesses whether the fees requested by a professional are “reasonable” for actual and “necessary” services rendered by such professional.²⁶² Lawyers are also subject to a similar standard under their ethical code of conduct enforceable by their respective state bars.²⁶³

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

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

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

262 Bankruptcy Code section 330(a) permits a court to award only “reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person,” and permits only “reimbursement for actual, necessary expenses.” 11 U.S.C. § 330(a)(1).

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

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

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

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

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

The last of these factors — that the arrangement is reasonably likely to be beneficial to the estate — was fully vetted by the Commission. Indeed, the Commissioners contemplated that this factor would allow courts to prospectively consider the impact of proposed alternative fee arrangements. In assessing such arrangements under this factor, courts could consider, among other things: (i) how the arrangement might work during the case and the likely impact (both positive and negative) on the estate given various scenarios; (ii) the professionals' justifications for the arrangement and any alternatives to the arrangement; (iii) the use of such arrangements in the market and whether the

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

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

proposed arrangement includes relevant and customary terms; and (iv) the overall potential benefit to the estate. The Commissioners underscored the need to have the court make these determinations at the beginning of the case or engagement, as applicable, to allow the professional, client, and estate to proceed with confidence in the bargain reached. This approach comports with market standards for alternative fee arrangements and promotes efficiency in their structure and use in chapter 11.

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

The Commissioners believed that, whatever the alternative fee agreement, the incentive for professionals to pursue such arrangements would depend, in part, on the willingness of courts to enforce the original terms of the fee agreement, subject to ordinary client defenses (including fraud or misrepresentation) and the current standard of review under section 328. The Commission agreed that the *ex ante* standard of review outlined above would provide appropriate incentives and a meaningful way for courts to assess alternative fee arrangements at the outset. On balance, the Commission determined that alternative fee structures and more flexibility and innovation in fee structures could generate significant cost savings for bankruptcy estates and could remove a barrier for many companies that could not otherwise afford to pursue a chapter 11 reorganization.

Finally, the Commission reviewed and evaluated recommended principles in other areas that, directly or indirectly, addressed professionals' fees and expenses. For example, the principles discuss the standard of review that should apply to any fees and expenses of professionals for any secured creditor or *ad hoc* committee that requests payment of those amounts from the estate. The Commission agreed that such fees and expenses should be subject to the reasonableness standard of section 330 of the Bankruptcy Code.²⁷⁰ The principles also clarify the process for the debtor's

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

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

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

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

retention and payment of nonbankruptcy professionals.²⁷¹ Furthermore, in reviewing and discussing the U.S. Trustee's appointment of multiple committees in a case, the Commission observed several examples of courts authorizing committees to share professionals.²⁷²

B. Financing the Case

1. Adequate Protection

Recommended Principles:

- The amount of adequate protection required under section 361 of the Bankruptcy Code to protect a secured creditor's interest in a debtor's property should be determined based on the foreclosure value of the secured creditor's collateral.
- Nothing in this principle prohibits the trustee from seeking to sell a secured creditor's collateral under section 363; in such a sale, the secured creditor's allowed secured claim should be determined by the value actually realized from the sale of its collateral under section 363. In the case of a chapter 11 plan contemplating a reorganization of the debtor, the secured creditor's allowed secured claim should be determined by the reorganization value of its collateral. For the definition of "reorganization value" (which is defined for both the plan and the section 363x sale contexts), see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.
- For purposes of these principles, the term "**foreclosure value**" means the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law. In evaluating foreclosure value, a court should be able to consider a secured creditor's ability to structure one or more sales, or otherwise exercise its rights, under applicable nonbankruptcy law, in a manner that maximizes the value of the collateral. In the case of a foreclosure sale in which the secured creditor would acquire the collateral through a credit bid, the foreclosure value should be based on the net cash value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale, and not on the face amount of the debt used to acquire the property through the credit bid.
- The foreclosure value of a secured creditor's collateral should be determined at the time of the request for, or agreement by the parties to provide, adequate protection under section 361. In granting adequate protection to a secured creditor under

²⁷¹ See *id.*

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

section 361(3), the court should be able to consider evidence that the net cash value that a secured creditor would realize upon a hypothetical sale of the secured creditor's collateral under section 363 exceeds the collateral's foreclosure value (a "*value differential*"). If the court makes a finding based on the evidence presented at the adequate protection hearing that a value differential exists, the court should be able to premise adequate protection under section 361, in whole or in part, on such value differential. In so doing, the court's order also should provide that, if the court determines at a subsequent hearing that the secured creditor has presented sufficient evidence to warrant relief from the automatic stay with respect to the collateral, the trustee will conduct a sale of the collateral under section 363, unless the secured creditor elects otherwise. For purposes of this principle, the court may not enforce any waiver or agreement affecting a court's ability to consider evidence and make determinations regarding the existence of a value differential or a secured creditor's entitlement to relief from the automatic stay.

- This formulation of adequate protection complies with the original purpose of section 506(a), which provides that value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a). Accordingly, the foreclosure value of a secured creditor's collateral should not necessarily determine the value of such collateral or the secured creditor's allowed claim for other purposes in the chapter 11 case.
- A secured creditor should continue to receive priority treatment under section 507(b) for the foreclosure value of its collateral at the time of its request for adequate protection under section 361. To the extent existing law has been interpreted by courts to mean that the secured creditor must be "provided" with adequate protection in order to gain this benefit, such case law should be overturned by statute. It is sufficient that the secured creditor be deprived of the requested relief from the automatic stay to implicate the protections of section 507(b).
- A court should be able to approve a provision to cross-collateralize a secured creditor's prepetition debt with the debtor's or the estate's postpetition property only for the purpose of providing adequate protection under section 361 and only to the extent that such cross-collateralization covers any decrease in the value of the secured creditor's collateral as of the petition date.
- The court should not approve any proposed adequate protection under section 361 that grants a lien on, or any direct or indirect interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code. Nevertheless, this prohibition should not limit the proceeds available to satisfy a prepetition secured creditor's claim arising solely under section 507(b).

Adequate Protection: Background

The filing of a chapter 11 case stays the enforcement of many creditors' actions against the debtor, including the collection and foreclosure actions of secured creditors. Moreover, following a filing, the debtor in possession²⁷³ may continue to use its property, including any cash collateral, to operate its business and to facilitate its reorganization efforts. Although the debtor's right to the automatic stay and the continued use of its property ultimately benefit all stakeholders, the debtor's exercise of these rights directly affects the rights of secured creditors holding interests in the debtor's property. On the other hand, allowing a secured creditor to foreclose immediately on the debtor's property or to demand payment in full from the debtor would crater the debtor's reorganization efforts at the outset; such a provision would essentially turn chapter 11 into a liquidation statute.

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

Section 361 offers three nonexclusive means for providing a secured creditor with adequate protection of its secured interest: (i) cash payments; (ii) a replacement lien; or (iii) other protection that will result in the realization of the indubitable equivalent of the secured creditor's interest in the property.²⁷⁶ The language of section 361 is permissive and suggests that other means for providing adequate protection may also exist. Nevertheless, courts and debtors in possession mostly rely on these three articulated means, with the types of adequate protection that would satisfy the third option — providing the indubitable equivalent of the secured creditor's interest — largely determined on a case-by-case basis.²⁷⁷

In addition, issues of valuation often are at the heart of the adequate protection determination. Courts have used a variety of valuation standards in assessing the sufficiency of adequate protection under section 361. These standards have included liquidation value, going concern value, and various market valuations.²⁷⁸ Section 361 does not specify the appropriate valuation standard. In the context

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

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

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

²⁷⁶ 11 U.S.C. § 361(1), (2), (3).

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

²⁷⁸ See, e.g., Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 Am. Bankr. Inst. L. Rev. 1, 2 & n. 5 (2012) ("Broadly speaking, a firm, its assets or its equity can be valued in one of four ways: (i) asset-based valuation where one estimates the value

of determining the value of a secured creditor's allowed claim, section 506(a) of the Bankruptcy Code provides that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."²⁷⁹

Adequate Protection: Recommendations and Findings

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

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

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

of a firm by determining the current value of its assets, (ii) discounted cash flow or 'DCF' valuation where one discounts cash flows to arrive at a value of the firm or its equity, (iii) relative valuation approaches, which include the 'comparable company analysis' and the 'comparable transaction analysis' that base value on how comparable assets are priced, and (iv) option pricing that uses contingent claim valuation.") (citing cases that considered these various methodologies).

279 11 U.S.C. § 506(a).

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

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

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

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

282 See generally Robert Rhee, *Essential Concepts of Business for Lawyers* 155–59 (2012) (explaining different ways to value a company).

283 A secured creditor may have interests in only certain of the debtor's assets or something less than the entirety of the enterprise. See, e.g., Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L.J. 862, 922–23 (2013) ("Yet, not all property can be encumbered by a security interest as a legal or practical matter. Whatever the intentions of the parties, the so-called blanket lien is likely to have gaps."). See also Edward Janger, *The Logic and Limits of Liens*, 2015 Ill. L. Rev. ___, at *5–6 (forthcoming 2015) (noting that so-called blanket liens under Article 9 of the Uniform Commercial Code may exclude tort claims, real estate, recoupment and setoff claims, insurance claims, and others); Michelle M. Harner, *The Value of Soft Assets in Corporate Reorganizations*, 2015 Ill. L. Rev. ___, at *24 (forthcoming 2015) ("If a company holds a going concern surplus ... some portion of that value is attributable to soft variables and, if realized postpetition, is not (or should not be) subject to a prepetition security interest. ... [There is] support for this position under the Bankruptcy Code."), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444699. But see *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 4–5 (Nov. 15, 2012) ("While some commentators have advocated limiting a secured creditor's interest to 'liquidation value' while preserving incremental 'going-concern surplus' for the benefit of others, CFA submits that prepetition lending expectations should be preserved. For example, with an increasingly large segment of the secured lending market dedicated 'cash-flow lending' predicated upon the present value of anticipated future income streams or cash-flows based upon a multiple of EBITDA, when those proceeds are realized upon a sale (whether voluntary or involuntary), the net proceeds of sale should be allocable to the secured party. On the other hand, consistent with pre-bankruptcy expectations, the secured creditor should also be required to bear the reasonable costs and expenses incurred in connection with the preservation and disposition of the collateral (a concept presently addressed by §506(c) of the Code). Accordingly, CFA believes that the Commission should consider codifying the principal that the secured creditor's interest includes the realizable value of the collateral including going-concern value."), available at Commission website, *supra* note 55.

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

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

In addition, the Commission agreed that a secured creditor should receive additional assurances if the court permits the debtor to provide adequate protection by showing a sufficient equity cushion in the property — *i.e.*, a sufficient differential between the foreclosure value and the section 363x sale value of the secured creditor's interest in the debtor's property. In this instance, the Commission determined that the court should have the ability to provide in the adequate protection order that, if the debtor in possession's reorganization efforts fail, or if the court subsequently finds cause that would support lifting the automatic stay with respect to the secured creditor's collateral, the debtor in possession or the chapter 11 trustee must sell the secured creditor's collateral under section 363 of the Bankruptcy Code, unless the secured creditor elects otherwise. This compromise reflects the reality that, if adequate protection is provided based on the reorganization value of the collateral, the secured creditor should have a means of realizing such reorganization value if adequate protection is subsequently proven to insufficiently protect the secured creditor's interests. Although the Commissioners discussed potential ways that secured creditors could try to impede the debtor's reorganization efforts by triggering their need for additional assurance, the Commission ultimately determined that the court could monitor such conduct by enforcing its orders. Moreover, the Commission concluded that such conduct is rare and likely counterproductive for the secured creditor, which would otherwise be entitled to receive the reorganization value (which is defined in the sale context as the actual sale price) of its collateral upon the confirmation of the debtor's plan or the approval of a section 363x sale.

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

The Commission also considered whether a debtor in possession should be able to grant a replacement lien in its chapter 5 avoidance actions or the proceeds of such actions to provide adequate protection to a secured creditor under section 361.²⁸⁶ The Commission reviewed the original policies underlying the trustee's avoiding powers under chapter 5 of the Bankruptcy Code, including allowing the trustee to avoid prepetition transfers that preferred certain unsecured creditors and reallocating the

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

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

recovered value from such avoidance actions more fairly through the bankruptcy claim distribution process. The Commissioners also observed that chapter 5 avoidance actions and recoveries often are among the few unencumbered assets of a debtor's estate and therefore may be the only resource available to repay unsecured claims. On balance, the Commission determined that the debtor in possession should not be permitted to use chapter 5 avoidance actions or recoveries to provide adequate protection to secured creditors. The only exception to this general rule is that if the adequate protection granted to a secured creditor is determined to be insufficient, then such secured creditor should be allowed to receive recoveries from avoidance actions through the creditor's superpriority claim under section 507(b) of the Bankruptcy Code.

2. Terms of Postpetition Financing

Recommended Principles:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that —
 - o the postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor; and
 - o the court finds that the proposed postpetition financing is in the best interests of the estate.
- A court should not approve any proposed postpetition financing under section 364 that grants a lien on, or any interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code.
- Subject to a 60-day restriction on milestones, benchmarks, and similar provisions (see Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*), a court should be able to approve, in a final order, permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364. For the definition of "permissible extraordinary financing provisions," see Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*.
- Any prepetition contractual prohibition on subordinated prepetition junior secured creditors offering or providing postpetition financing to the debtor should not be enforced in the chapter 11 case, provided that: (i) any such subordinated prepetition junior secured creditors should not be permitted to prime the perfected security interests of the prepetition senior secured creditors with the postpetition financing

facility; and (ii) if the court approves the postpetition financing facility offered by the subordinated prepetition junior secured creditors, the prepetition senior secured creditors should have the option to match the terms of, and to provide the financing facility in lieu of, the subordinated junior secured creditors within a reasonable time as specified in the court's interim order approving the postpetition financing. These provisions would render unenforceable any contractual damages provisions that would otherwise allow prepetition senior secured creditors to recover damages for breach of contract against subordinated prepetition junior secured creditors under nonbankruptcy law based on the provision of postpetition financing. Sections 364 and 510 should be amended accordingly.

Terms of Postpetition Financing: Background

A debtor in possession²⁸⁷ needs liquidity to operate its business during the chapter 11 case and to finance its reorganization efforts. Some debtors in possession may be able to use cash collateral and its ongoing revenue streams for these purposes, but many debtors need a new, postpetition financing facility to achieve their postpetition objectives.²⁸⁸ Section 364 of the Bankruptcy Code generally governs a debtor in possession's requests to obtain postpetition financing.

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

Because a debtor in possession may not be able to prime its prepetition secured lenders under the current standards for adequate protection, a debtor in possession often tries to negotiate a postpetition financing facility with its prepetition secured lenders. Such postpetition facilities may include cross-collateralization or roll-up provisions that provide additional protection to the prepetition lenders on their prepetition claims against the estate. Whether a court should approve cross-collateralization

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

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

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

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

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

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

and roll-up provisions is subject to debate and frequently depends on the jurisdiction in which the chapter 11 case is pending.²⁹³ In addition, the debtor may be limited to negotiating its postpetition financing facility with only its prepetition senior secured creditors if the debtor's prepetition junior secured creditors are prohibited from extending postpetition financing to the debtor pursuant to a prepetition intercreditor or subordination agreement.²⁹⁴

Terms of Postpetition Financing: Recommendations and Findings

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

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

293 For cases allowing cross-collateralization, see *In re Ames Dep't Stores, Inc.*, 115 B.R. 34, 39–40 (Bankr. S.D.N.Y. 1990); *In re FCX, Inc.*, 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985); *In re Vanguard Diversified, Inc.*, 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *In re Gen. Oil Distrib., Inc.*, 20 B.R. 873, 875–76 (Bankr. E.D.N.Y. 1982). For cases disallowing cross-collateralization, see *Shapiro v. Saybrook Mfg. Co., Inc.* (*In re Saybrook Mfg. Co., Inc.*), 963 F.2d 1490, 1494–96 (11th Cir. 1992) (cross-collateralization is *per se* impermissible); *In re Texlon Corp.*, 596 F.2d 1092 (2d Cir. 1979); *In re Fontainebleau Las Vegas Holdings, LLC*, 434 B.R. 716 (S.D. Fla. 2010). For cases allowing roll-ups in certain circumstances, see *In re Uno Rest. Holdings Corp.*, Ch. 11 Case No. 10-10209 (MG) (Bankr. S.D.N.Y. Jan. 20, 2010); *In re Foamex Int'l Inc.*, Ch. 11 Case No. 09-10560 (KJC) (Bankr. D. Del. Feb. 18, 2009); *In re Aleris Int'l, Inc.*, Ch. 11 Case No. 09-10478 (BLS) (Bankr. D. Del. Feb. 12, 2009); *In re Tronox Inc.*, Ch. 11 Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. Jan. 12, 2009); *In re Lyondell Chem. Co.*, Ch. 11 Case No. 09-10023 (REG) (Bankr. S.D.N.Y. Jan. 6, 2009). Notably, the permissibility of these and other provisions in a postpetition facility are governed by section 364 of the Bankruptcy Code and are generally protected on appeal and subject only to reversal if lack of good faith is established. See 11 U.S.C. § 364(e).

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

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

296 See, e.g., Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 Iowa J. Corp. L. 469, 488 (“A system-wide lending failure like the recent credit crisis raises the question whether private sources of bankruptcy financing will always be available. Through much of 2008, few companies that filed for bankruptcy were able to obtain financing.”); Robert H. Barnett & Brian J. Grant, *Credit Crisis Puts Focus on Out-of-Court Restructurings*, J. Corp. Renewal, June 14, 2010 (“DIP financing sources seized up at the onset of the credit crunch and banking crisis in 2008. Several large institutions in the third quarter of that year dramatically tightened new DIP lending; Lehman Brothers filed for bankruptcy in September of 2008, and Merrill Lynch and Wachovia, two other top players in the market, were sold in last-minute distressed deals to Bank of America and Wells Fargo, respectively. As credit vanished throughout the financial system, other DIP lenders followed suit. . . . [T]he number of active DIP lenders dropped from more than 30 at the beginning of 2008 to only five or six by the end of the year. Aside from some high-profile deals in which lenders pulled together to support large companies (such as Lyondell Chemical Co.'s \$8 billion Postpetition financing facility, which came with a 13 percent interest rate and a 7 percent fee), DIP financing remained scarce in 2009, forcing companies either to restructure by other means or to move straight to liquidation.”), available at <http://www.turnaround.org/Publications/Articles.aspx?objectID=13015>.

Syndications and Trading Association (the “LSTA”).²⁹⁷ The LSTA’s data suggest that the majority of debtors that enter into postpetition financing agreements do not liquidate, but rather reorganize.²⁹⁸ Specifically, based on the Commission’s review of the LSTA data: (i) 69 percent of firms that had postpetition financing reorganized, whereas 52 percent of firms that did not have postpetition financing reorganized; (ii) 38 percent of firms without postpetition financing liquidated, whereas 23 percent of firms with postpetition financing liquidated; (iii) 16 percent of firms that had postpetition financing were eventually sold pursuant to a section 363 sale, whereas only 8 percent of firms that did not have postpetition financing were sold pursuant to a section 363 sale; and (iv) any relationship between postpetition financing agreements and chapter 7 liquidations is inconclusive.²⁹⁹

In addition, the Commissioners evaluated testimony that (i) markets for secured leveraged debt, especially with the benefits of senior secured status, and high-yield bonds are large and critical to economic growth; (ii) secondary trading markets are deep and liquid even during times of great distress; (iii) assets in bankruptcy are liquid and volatile, but can appreciate and increase the enterprise value or provide a less certain path toward profitability; and (iv) debtor in possession financing provides much needed liquidity to distressed companies at market rates based on the risk profile of the particular debtor.³⁰⁰ They also considered testimony that postpetition financing agreements include tighter covenants and milestones often designed to facilitate a loan-to-own

²⁹⁷ The LSTA dataset is found at Exhibit B, with related materials at Exhibits A and C, to Mr. Shapiro’s supplemental testimony. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at Exhibits A, B, C (Nov. 30, 2012), available at Commission website, *supra* note 55. See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

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

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

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

transaction for the lender or a sale of the assets in the chapter 11 case.³⁰¹ In reviewing the testimony, the Commissioners debated the advantages and disadvantages of postpetition financing terms.³⁰²

As a general matter, the Commissioners recognized the need for a robust, competitive postpetition financing market and the value it provides to distressed companies. They also appreciated the potential impact that any suggested reforms might have on that market; they aimed to encourage a competitive postpetition financing market that provided debtors with access to necessary financing on terms that would facilitate their restructuring efforts — an outcome that benefited all stakeholders. Accordingly, the Commissioners carefully analyzed the materials discussing, and the implications of issues involving postpetition financing. The Commissioners further acknowledged that the focus of section 364 should be on permitting parties to negotiate market agreements that do not overreach or negatively impact the rights of other stakeholders beyond the terms necessary to obtain postpetition credit in a particular case.

To strike this balance, the Commissioners first evaluated the use of roll-up and cross-collateralization provisions in postpetition facilities. The Commissioners discussed the different kinds of roll-up provisions and their different justifications, specifically comparing provisions in postpetition facilities provided by a prepetition lender with provisions in postpetition facilities provided by a completely new lender.³⁰³ The Commissioners generally agreed that the greatest opportunity for abuse in the context of roll-up provisions occurs when a prepetition lender provides a postpetition

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

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

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

facility and the true “new credit” extended by such facility may be nominal (or nominal in relation to the amount of prepetition debt rolled up into the postpetition facility).³⁰⁴ Although the Commission viewed a refinancing with a new lender differently, the Commission also noted the potential challenge in distinguishing among prepetition and postpetition lending groups. To assist in this task, the Commission methodically worked through the various scenarios in which one or more prepetition lenders may participate in a postpetition facility that provides new credit to the debtor in possession. The Commission crafted the related principles to allow roll-up provisions in those circumstances if certain conditions are met, but to disallow roll-up provisions that provide little or no value to the estate.

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

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

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

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

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

other things, this waiver often removes an interested and viable source of financing from the debtor's pool of potential postpetition lenders, which may affect both the availability and terms of any postpetition financing for the debtor in possession.

The Commissioners recognized that this kind of waiver is increasingly common in intercreditor agreements, along with a variety of other provisions that affect bankruptcy rights, including rights of the debtor and potentially other nonparties to the intercreditor agreement. The Commissioners discussed the role and value of these provisions from the perspective of the prepetition senior secured lenders. The Commissioners debated different ways to provide the debtor with the ability to discuss postpetition financing with junior lenders subject to this kind of waiver while still respecting the interests of the prepetition senior secured lenders. The Commission reached a consensus that would allow a subordinated junior secured lender subject to this kind of waiver and prohibition to provide postpetition financing to the debtor on two conditions: (i) the proposed facility does not prime the liens of the prepetition senior secured lender, and (ii) if the court approves the postpetition facility offered by such junior lenders, the prepetition senior secured lender has the right to step in and provide postpetition financing (in lieu of the financing offered by the junior lender) to the debtor on the same terms and subject to the same conditions as the postpetition facility offered by the junior secured lender and approved by the court. In that event, the Commission supported an amendment to the Bankruptcy Code rendering unenforceable any contractual damages provisions that would otherwise allow senior secured creditors to recover damages for breach of contract against junior secured creditors under nonbankruptcy law based on the provision of postpetition financing.³⁰⁶ In addition, the Commission agreed that the senior secured lenders should be required to take such action within a reasonable time as directed by the court in the interim financing order.

C. Breathing Spell for Debtor upon Filing

1. Timing of Approval of Certain Postpetition Financing Provisions

Recommended Principles:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that (i) is subject to milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions within 60 days after the petition date or date of the order for relief,

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

whichever is later, or (ii) otherwise conflict with another section of the Bankruptcy Code.

- In this context, the phrase “*milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions*” refers to tasks or conditions that relate in a material or significant way to the debtor’s operations during the chapter 11 case or to the resolution of the case, including deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and a chapter 11 plan. It does not include payment of scheduled loan amounts, customary loan covenants, reporting requirements, ministerial tasks, or the debtor’s compliance with a budget, provided that the budget does not impose disguised milestones or benchmarks.
- A court should not approve permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364 in any interim order.
- In this context, “*permissible extraordinary financing provisions*” include: (i) milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions; (ii) representations regarding the validity or extent of the creditor’s liens on the debtor’s property or property of the estate; or (iii) if some or all of the proposed postpetition lenders hold prepetition debt that would be affected by the postpetition facility, a provision that refinances prepetition debt with proceeds of the postpetition facility that is otherwise permissible under the principles relating to postpetition financing terms. *See* Section IV.B.2, *Terms of Postpetition Financing*.
- For the recommended principles on section 506(c) and section 552(b), see Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.

Timing of Approval of Certain Postpetition Financing Provisions: Background

Although an often necessary and critical source of postpetition liquidity, the postpetition facility negotiated between a debtor and its postpetition lenders may be subject to terms that could affect the chapter 11 case. For example, the terms of the proposed postpetition financing may require the debtor in possession³⁰⁷ to pursue a sale process under section 363 of the Bankruptcy Code on an expedited basis; may set certain deadlines for the debtor to file its disclosure statement and chapter 11 plan; may contain waivers of certain rights held by the debtor in possession under the Bankruptcy Code, such as the right to assert surcharges under section 506(c); or may exclude the application of certain other provisions of the Bankruptcy Code, such as the equities of the case exception under section

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

552(b). The facility may also be subject to provisions addressing the validity of any prepetition liens of the lenders, granting a lien in chapter 5 avoidance actions and any recoveries thereon, and default or termination provisions tied to a variety of developments in the particular chapter 11 case, such as motions for relief from the automatic stay or challenges to the liens held by postpetition lenders.

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

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

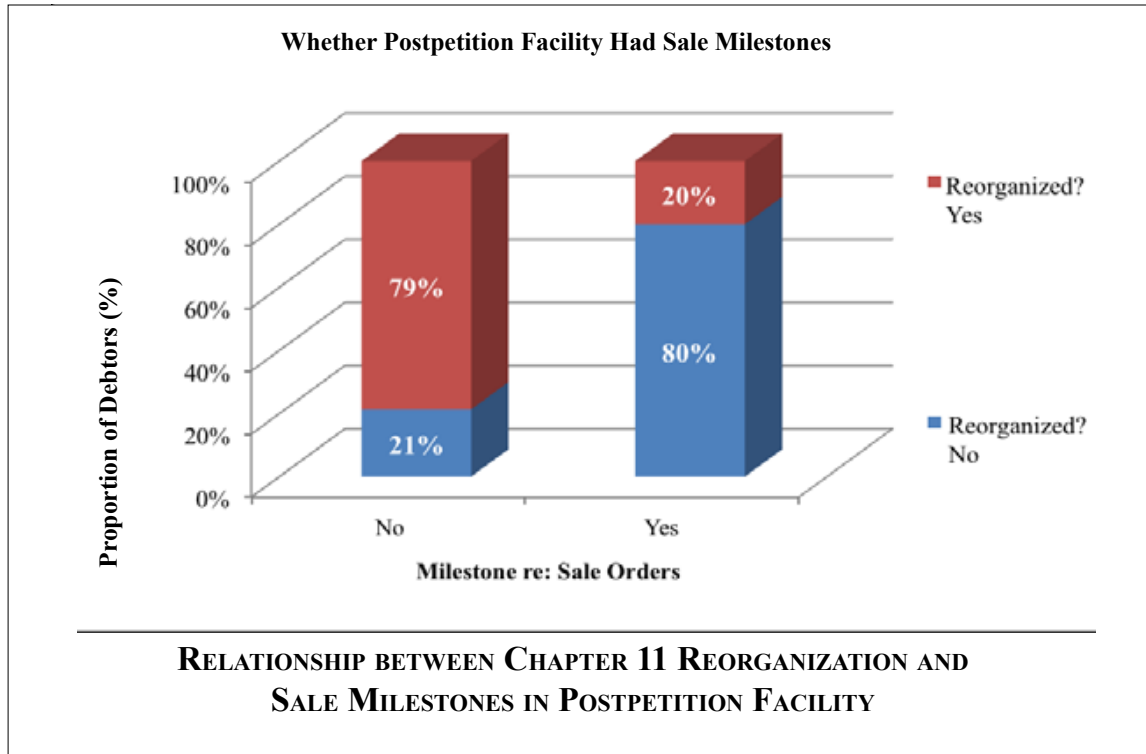
The Commissioners discussed at length the potential impact of terms in a postpetition credit agreement that dictate or attempt to influence the course of the chapter 11 case, or that implement waivers of, or otherwise affect, rights under the Bankruptcy Code.³⁰⁹ The Commissioners identified a variety of provisions that may fall into this category, including (i) milestones and benchmarks that require the debtor to take certain actions or satisfy certain conditions by deadlines set forth in the postpetition financing documents; (ii) concessions regarding the validity or enforceability of prepetition liens; (iii) deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and chapter 11 plan; and (iv) waivers of, or stipulations concerning, the section 506(c) surcharge and the section 552(b) equities of the case exception.³¹⁰ Although Bankruptcy Rule 4001(c) requires the debtor to summarize these kinds of provisions, parties in interest may not have sufficient time or information to accurately assess the import of such provisions and the impact they may have on the case. Notably, the data compiled by the LSTA included information concerning postpetition financing with the following kinds of milestones or benchmarks: “Milestone re Bidding Procedures Orders,” “Milestone re Sale Orders,” “Milestone re Closing a Sale,” and “Conditions for

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

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

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

the Bidding Process for a 363 Sale.”³¹¹ A review of the 112 observations in the LSTA dataset with postpetition financing agreements (112 of 167 total sample) revealed that a postpetition facility subject to certain milestones or benchmarks in the chapter 11 case actually produced the required result — *i.e.*, postpetition credit agreements that required a section 363 sale resulted in a section 363 sale, and postpetition credit agreements that required the filing of a plan resulted in a confirmed plan.³¹² Moreover, postpetition financing facilities with sale-oriented milestones were significantly less likely to result in a reorganization, as shown in the table below.³¹³



311 These milestones are defined as follows:

Milestone re Bidding Procedures Orders: If there was DIP Financing, was it an event of default not to have an order approving the bidding procedures for a sale of substantially all of the debtor's assets entered by a certain date? Yes/No.

Milestone re Sale Orders: If there was DIP Financing, was it an event of default not to have an order approving a sale of substantially all of the debtor's assets entered by a certain date? Yes/No.

Milestone re Closing a Sale: If there was DIP Financing, was it an event of default not to [close a sale] by a certain date? Yes/No.

Conditions for the Bidding Process for a 363 Sale: If there as a DIP Financing, did it the process under which any auction of the debtor's assets had to occur? Yes/No.

Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at Exhibit A p.4 (Nov. 30, 2012), available at Commission website, *supra* note 55.

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

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

The Commissioners discussed ways to provide more effective notice of these kinds of provisions to the unsecured creditors' committee and other parties in interest in the debtor's chapter 11 case, and highlighted the need to provide these parties with sufficient time to review and vet such provisions. In light of the potentially significant impact of these provisions on chapter 11 outcomes, the Commission determined that such extraordinary provisions in postpetition facilities should be highlighted and clearly explained in the motion seeking approval of the postpetition financing. In addition, the Commission agreed that (i) such extraordinary provisions should not be subject to approval in an interim order, and (ii) milestones, benchmarks, or similar provisions should not be permitted to take effect until at least 60 days after the petition date.

2. Timing of Section 363x Sales

Recommended Principles:

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

Timing of Section 363x Sales: Background

Section 363 of the Bankruptcy Code currently allows the trustee³¹⁴ to sell assets in the ordinary course of business as well as outside the ordinary course of business during the chapter 11 case.³¹⁵ A sale outside the ordinary course of business requires, among other things, notice and a hearing. It also typically requires an auction and public sale process.³¹⁶ Although courts frequently use the

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

³¹⁵ 11 U.S.C. § 363(b), (c).

³¹⁶ *See* Rachael M. Jackson, *Survey: Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, 2005 Colum. Bus. L. Rev. 451, 469–70 (2005) (“The process of conducting an auction generally establishes that a successful bidder has paid the fair market value for the asset. Therefore, considering the tremendous emphasis that bankruptcy courts place on maximizing the value of the estate, auction sales are advisable because judges do not tend to scrutinize closely such transactions before approving the final sale. In addition, the security of an auction sale is enhanced because appellate courts review bankruptcy court confirmations with considerable deference and, therefore, disgruntled bidders are rarely successful in challenging a court-approved sale.”); Brett Rappaport & Joni Green, *Calvinball Cannot Be Played on This Court: The Sanctity of Auction Procedures in Bankruptcy*, 11 Norton J. Bankr. L. & Prac. 189, 193 (2002) (“Public auctions are preferred over private auctions to ensure a market price, so that optimal return can be realized for creditors.”); Philip A. Schovanec, *Bankruptcy: The Sale of Property Under Section 363: The Validity of Sales Conducted Without Proper Notice*, 46 Okla. L. Rev. 489, 498 n. 63 (1993) (“While bankruptcy sales may be conducted privately, a public auction is usually held because

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

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

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

Prior to the early 2000s, a traditional chapter 11 sale process under section 363 could take at least three months, if not more.³²¹ This course typically involved a thorough postpetition marketing and

competitive bidding ensures that fair and valuable consideration is received, thus helping to avoid any suspicion of collusion or impropriety.”).

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

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

Id. at 1069–70.

318 11 U.S.C. § 1129(a), (b).

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

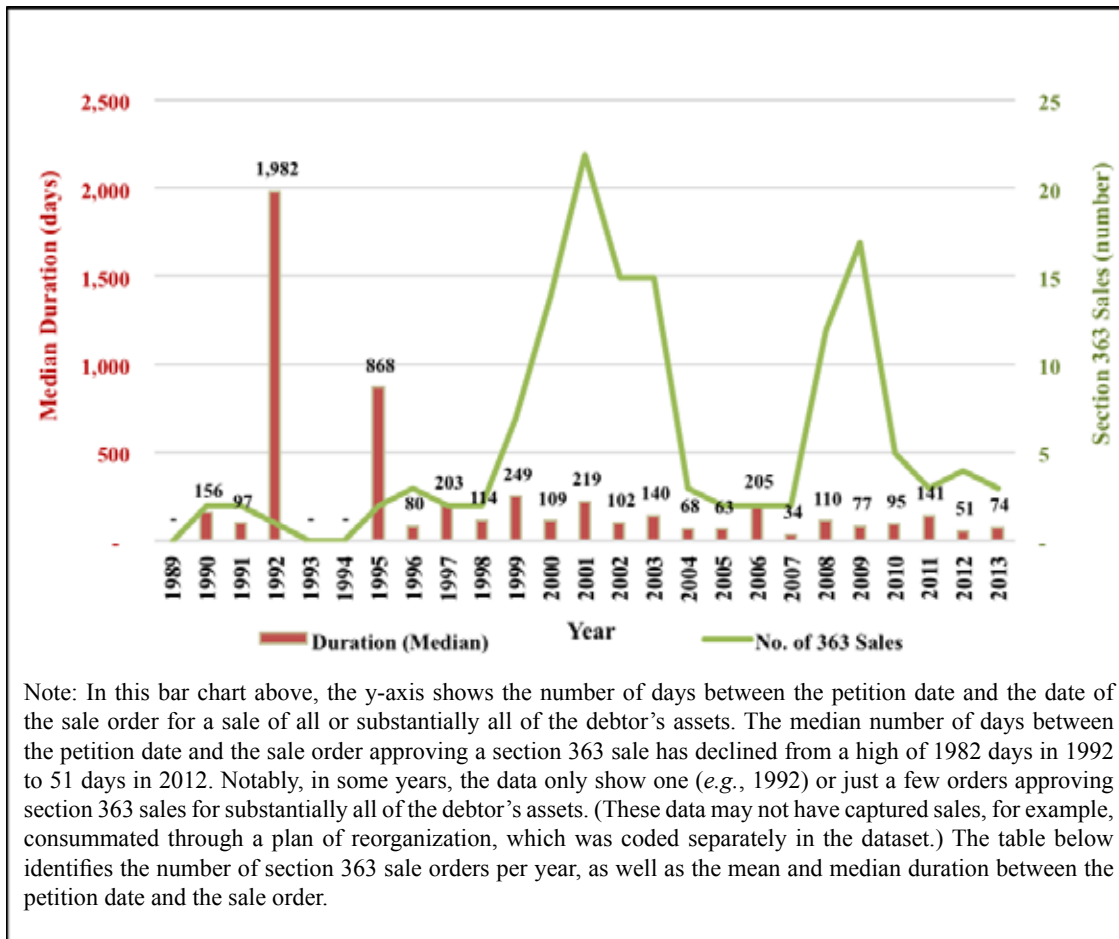
320 See Section VI.B, *Approval of Section 363x Sales*.

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

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auction process; sufficient opportunity for notice, objections, and hearings on both the auction process and sale transaction; and the closing of the sale.³²² This practice allowed the court, the debtor in possession, the U.S. Trustee, and parties in interest a full opportunity to consider the value of the assets and alternatives to a sale, instilled a certain level of confidence in the bankruptcy sale process, and resulted in the conclusion that the approved sale was in the best interests of the estate.

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



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

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

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

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

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

Timing of Section 363x Sales: Recommendations and Findings

The Commissioners examined the process relating to a sale of all or substantially all of a debtor’s assets (referred to as a “section 363x sale” in these principles) at great length. In addition to reconsidering

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

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

the standard of review and substantive requirements for section 363x sales, the Commission also scrutinized the timing issues surrounding these sales.

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

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

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

D. Payment of Certain Claims upon Filing

When a debtor files a chapter 11 case, the automatic stay of section 362 of the Bankruptcy Code prohibits the debtor in possession from paying any prepetition claims outside the chapter 11 plan or without prior approval of the court. A key factor underlying this prohibition is that sections 507 and 1129 of the Bankruptcy Code incorporate a fairly stringent priority scheme for the payment of prepetition claims. Payments outside the chapter 11 plan may result in an unfair allocation of value among stakeholders in the chapter 11 case.

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

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

1. Prepetition Claims and the Doctrine of Necessity

Recommended Principles:

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

Prepetition Claims and the Doctrine of Necessity: Background

The doctrine of necessity originates from the early railroad equity receivership cases.³²⁸ In those cases, courts generally granted priority status to the railroad’s current operating expenses that were incurred within six months of the filing and were deemed necessary to keep the railways and interstate commerce moving.³²⁹ Although not expressly authorized by the Bankruptcy Code, courts have continued to invoke the doctrine of necessity³³⁰ in certain circumstances under the court’s general equitable powers set forth in section 105(a) of the Bankruptcy Code.³³¹

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

329 *Id.*

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

331 Section 105(a) provides:

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

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

Debtors in possession³³² commonly rely on the doctrine of necessity and the court's equitable powers when requesting authority to pay prepetition claims outside the chapter 11 plan. One type of claim that a debtor in possession seeks to pay is the so-called "critical vendor" claim. "**Critical vendors**" are commonly defined as essential vendors or suppliers who are indispensable to the debtor's business — either because of the types of goods or services they supply, their knowledge of the debtor's business, or some other unique aspect to the business relationship — and without whom the debtor likely cannot achieve a successful reorganization.³³³ A debtor's request typically will propose conditions for the payment of these claims, such as percentage payments and an agreement that the vendor or supplier will continue with the debtor on the same terms as their prepetition agreement. Courts authorizing the payment of critical vendor claims generally rely on the doctrine of necessity and section 105(a).³³⁴ Notably, not all courts agree that the doctrine of necessity and section 105(a) can be used for these purposes.³³⁵

Prepetition Claims and the Doctrine of Necessity: Recommendations and Findings

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

The Commission reviewed justifications most commonly articulated to support critical vendor payments. These include a debtor's need to: (i) continue to receive a steady supply of goods and services required for the operation of the debtor's business; (ii) appease creditors who threaten to discontinue supply or services without payment; (iii) obtain products from a single-source supplier; (iv) comply with applicable state or other nonbankruptcy law that requires performance on a contract and is not otherwise preempted by the Bankruptcy Code; and (v) make payments that may be necessary for the survival of a key vendor.³³⁷ The Commissioners noted the danger of viewing

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

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

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

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

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

337 See, e.g., *J.M. Blanco, Inc. v. PMC Mktg. Corp.*, 2009 WL 5184458, at *2 (D.P.R. Dec. 22, 2009) (debtor offered evidence to support that critical vendor supplied "merchandise [that] was critical and that no other vendor was available to offer the same inventory under equal terms and conditions"); *In re Tropical Sportswear Int'l Corp.*, 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005) ("This Court finds that the Debtors' situation with its Critical Vendors is precisely the situation where critical vendor status is warranted. Each of the four Critical Vendors is a major supplier of specialty goods or services to the Debtors, and any interruption in the flow of their products to the Debtors would substantially jeopardize the Debtors' ability to conduct business. As such, the Critical

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these needs in isolation without considering the rights of other stakeholders and commonly applied protections of the Bankruptcy Code, such as the automatic stay in section 362.

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

The Commission decided to recommend that the Bankruptcy Code specifically authorize the payment of prepetition claims to vendors for goods and services in certain instances, provided that such vendors are not eligible for administrative priority under section 503(b)(9). (As discussed in the context of section 503(b)(9), the Commissioners found that the priority afforded to vendor claims under section 503(b)(9) should provide sufficient protection and incentive for vendors to continue doing business with the debtor in possession.) In reaching its conclusion, the Commission recognized that certain vendors may in fact be indispensable to the debtor's reorganization but not be eligible for section 503(b)(9) treatment and unable to perform without some compromise and payment of their prepetition claims. The Commission determined, however, that the standard should be stringent and require evidence to establish why, for example, the debtor cannot obtain the particular services from another source, the state law obligation is not preempted by the Bankruptcy Code, or the state law obligation is not otherwise deemed an impermissible disguised priority. The Commission agreed that clarifying the court's ability to authorize the payment of prepetition vendor claims under the Bankruptcy Code would reduce uncertainty and litigation, as well as the related costs, for the estate and creditors.

In the context of prepetition vendor claims for goods, the Commission considered instances in which state law might prohibit a nondebtor party from providing goods to a debtor that has not paid a vendor's invoices. The Commissioners analyzed whether the Bankruptcy Code needed to provide the court and the debtor in possession some flexibility in this context to preserve the business. In so doing, the Commissioners discussed the federal preemption doctrine, which is rooted in the

Vendors are absolutely critical to the maintenance of the Debtors' estates." See also Joseph Gilday, "Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code, 11 Am. Bankr. Inst. L. Rev. 411, 416 (2003) ("Debtor's counsel usually claims that losing such services or products would have, in the words of one, a 'severely pernicious effect on [its] efforts to rehabilitate and reorganize.' The inability to operate its business as it normally does would decrease the debtor's cash flow and cripple its operations before it had a chance to propose a reorganization plan, according to its counsel.") (citations omitted).

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

Supremacy Clause of the U.S. Constitution,³³⁹ and its well-established application to override state bankruptcy laws that interfere with federal bankruptcy law.³⁴⁰ The distributional requirements and priority rules under Bankruptcy Code section 507 therefore preempt any contrary state laws that seek to grant priority to certain claims.³⁴¹ For example, Bankruptcy Code section 545 was enacted specifically to preempt statutory liens that are not good against a *bona fide* purchaser under state law.³⁴² The Commissioners analyzed these concepts in trying to balance a debtor in possession's need to satisfy a nonbankruptcy law requirement that was not a disguised priority in order to continue its business operations and the general restraints of the doctrine of necessity and federal bankruptcy priorities. In striking this balance with respect to state laws applicable to vendor goods, the Commission articulated a standard similar to that imposed by courts under section 545: courts should not authorize payment of prepetition claims that become due upon the debtor's insolvent financial condition or the commencement of the debtor's bankruptcy case, or have no legitimate purpose outside the bankruptcy context.³⁴³

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

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

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

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

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

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

2. Wage and Benefits Priorities

Recommended Principles:

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

Wage and Benefits Priorities: Background

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

Employees, in turn, frequently depend on timely payments from their employers for their livelihood and subsistence. As observed by one court: "The bankruptcy act, while primarily intended to secure an equal distribution of the assets of the bankrupt among his creditors, evinces a strong intent on the part of Congress to protect those who are dependent on their daily earnings for their support."³⁴⁴ In this respect, employees arguably differ from other creditors who either may have other revenue sources in addition to payments owed and made by the debtor, or may have a greater capacity to perform diligence on the debtor to negotiate for stronger contractual protections and leverage.³⁴⁵

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

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

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

Id.

Priority treatment for wage claims under U.S. bankruptcy laws has a long history.³⁴⁶ Their priority was clearly articulated in the short-lived 1841 Act, and was included and refined in the laws that followed. Such priority was initially limited to certain kinds of employees, but more recent laws have focused on limiting this priority based on (i) when the wages were earned and (ii) the amount of wages earned.³⁴⁷

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

Wage and Benefits Priorities: Recommendations and Findings

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

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

Finally, the Commissioners discussed the common practice by debtors in possession³⁵⁰ of filing a first-day motion requesting authority to pay employee wages and benefit plan contribution claims, typically on the ground that such claims are entitled to priority treatment under section 507. Such

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

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

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

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

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

motions and the attendant responsive pleadings, hearings, and orders unnecessarily consume both debtor and judicial resources and can delay the debtors' normal payroll cycles, even though these motions are often noncontroversial and ultimately granted by the court. Many courts, debtors, and commentators recognize the value to the debtor of receiving uninterrupted service from its employees. Accordingly, the Commission recommended that section 549 of the Bankruptcy Code be amended to allow the debtor in possession to pay wage priority and benefit plan priority claims up to the proposed per-employee priority cap, pursuant to section 507(a)(4) and (5) without an order of the court, provided that the debtor files a notice of the amount of such proposed payments.

E. Financial Contracts, Derivatives and Safe Harbor Provisions

The filing of a chapter 11 case typically effects an automatic stay of, among other things, all prepetition collection efforts against the debtor, its property, and property of the estate.³⁵¹ In addition, counterparties to many prepetition executory contracts with the debtor cannot unilaterally terminate their contracts or otherwise affect the debtor's rights under such contracts, and the trustee may avoid prepetition fraudulent and preferential transfers.³⁵² The Bankruptcy Code, however, exempts certain kinds of financial contracts from these and certain other bankruptcy provisions. These exemptions generally cover financial contracts qualifying as a securities contract, commodities contract, forward contract, repurchase agreement, swap agreement, or master netting agreement (collectively referred to as "qualified financial contracts").³⁵³

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

351 11 U.S.C. § 362(a).

352 *Id.* §§ 365, 547, 548.

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

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

355 The legislative history provides, in relevant part:

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

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

necessary to prevent the insolvency of one commodity or securities firm from spreading to other firms and [possibly] threatening the collapse of the affected market.”³⁵⁶

Congress further expanded the safe harbors in 1982, 1990, 1994, 2005, and 2006.³⁵⁷ Some commentators argue that these amendments expanded the safe harbors well beyond their original purpose and now impede a debtor’s reorganization efforts to the detriment of other stakeholders.³⁵⁸ The Commission considered the important role that the safe harbors play in financial markets and carefully balanced the competing concerns throughout its deliberations. As described below, the Commission recommended certain targeted amendments to the safe harbors that continue protections for qualified financial contracts in appropriate circumstances, but reduce opportunities for manipulation or abuse.

1. Scope of Section 546(e) Safe Harbors

Recommended Principles:

- Section 546(e) of the Bankruptcy Code should be amended to remove protection from avoidance actions for beneficial owners of privately issued securities in connection with prepetition transactions using some or all of the debtor’s assets to facilitate the transaction (*e.g.*, leveraged buyouts).
- Section 546(e) should continue the existing protection from avoidance actions for (i) securities industries participants who act as conduits in both public and private securities transactions and (ii) public securities holders.
- Section 546(e) and the parallel provisions of section 546 applicable to other qualified financial contracts should continue to exclude from the safe harbors transfers made with actual intent to hinder, delay, or defraud, and such transfers should remain voidable under section 548(a)(1)(A).
- The exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud should also apply to transfers made with similar intent that are

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

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

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

voidable under applicable state fraudulent transfer or conveyance laws avoidable by the trustee under section 544(b).

- o For purposes of this principle, a publicly issued security should include a security of a debtor or its affiliate that is registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. § 78l) or sold in reliance on Rule 144A or Regulation S under the Securities Act of 1933 (15 U.S.C. § 77a *et seq.*).

Scope of Section 546(e) Safe Harbors: Background

Section 546(e) of the Bankruptcy Code protects certain types of transactions from avoidance by the trustee³⁵⁹ under sections 544, 545, 547, 548(a)(1)(B) and 548(b). (These sections generally allow the trustee to avoid, among other things, prepetition fraudulent or preferential transfers, as well as unperfected securities interests, and to recover the value of those transfers for the benefit of the estate.) Specifically, a trustee may not avoid a margin payment or settlement payment made by, to, or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency. In addition, similar protection applies to transfers made by, to, or for the benefit of any of these parties in connection with a securities contract.

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

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

³⁶⁰ 11 U.S.C. § 741.

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

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

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

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

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

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

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

In these instances, the Commissioners found it difficult to reconcile the protections that courts were affording the beneficial owners of privately issued securities with the original purpose of the legislation. The Commissioners were most troubled by situations involving prepetition transfers in connection with an LBO that leaves the debtor with insufficient capital and that is attributable, at least in part, to bad faith on the part of the debtor’s insiders. Absent the section 546(e) safe harbor that has been extended to LBO transactions, the debtor in possession could challenge such a prepetition transfer as a fraudulent transfer³⁶⁴ and possibly avoid it for the benefit of the estate and other stakeholders harmed by the depletion in the debtor’s value. Nevertheless, section 546(e) prevents the debtor in possession from bringing fraudulent transfer claims, even against insiders of the debtor, unless the transfer was made within two years before bankruptcy and with actual intent to hinder, delay, or defraud creditors.

In balancing the competing considerations in the LBO context, the Commissioners discussed the need to continue to protect securities industries participants that act as conduits in prepetition transfers. The

acquire a beneficial interest in the funds that they handle. The ‘mere conduit’ argument is an outlier in the debate regarding section 546(e).” *Id.* at 609–10 (citations omitted).

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

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

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Commissioners noted that the beneficial owner of the privately issued securities should be deemed the initial transferee for purposes of fraudulent transfer law, and that conduits should not be affected by any limited change to section 546(e) in this respect. The Commission agreed, however, that conduits should be expressly covered by section 546(e) to avoid any uncertainty that might implicate the financial markets.

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

Another issue that arises with respect to the section 546(e) safe harbor is whether its protections are limited to fraudulent transfer actions under section 548 of the Bankruptcy Code or whether they also extend to such actions under state law that are avoidable by the trustee under section 544(b) of the Bankruptcy Code or avoidable by a litigation trust or individual creditors after confirmation of a chapter 11 plan. The courts are split on this issue. Even though the statute purports to limit the trustee's ability to bring avoidance actions, some courts have extended the protection to preclude state law causes of actions.³⁶⁵ Other courts have held that “there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights, by plain meaning analysis or otherwise.”³⁶⁶ The Commission evaluated each of these positions and discussed the practical consequences of allowing state law actions to proceed while precluding federal causes of action brought by the trustee on behalf of the estate. Ultimately, the Commission concluded that the exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud should apply whether the action is brought under federal or state law. Thus, the trustee will be able to avoid an actual intent fraudulent transfer whether brought under section 544(b) or 548. The Commission was not able to reach a consensus on extending the protections of the section 546(e) safe harbor to actions outside a federal bankruptcy case.

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

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

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

2. Treatment of Repurchase Agreements Under Safe Harbors

Recommended Principles:

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

Treatment of Repurchase Agreements Under Safe Harbors: Background

Sections 555 and 559 of the Bankruptcy Code allow certain parties, including financial institutions and financial participants, to liquidate, terminate, or accelerate a securities contract or repurchase agreement without relief from the automatic stay of section 362 or concern for the prohibition on enforcement of *ipso facto* clauses in section 365(e) of the Bankruptcy Code.³⁶⁷ In addition, the automatic stay generally does not apply to setoffs and the exercise of other remedies by the nondebtor party under a repurchase agreement.³⁶⁸ Section 559 was added to the Bankruptcy Code in 1984 to treat repurchase agreements the same as commodities and securities contracts under the safe harbors, in large part to protect the financing of the national debt.³⁶⁹

³⁶⁷ 11 U.S.C. §§ 555, 559.

³⁶⁸ *Id.* § 362(b)(7).

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

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

Some commentators have questioned whether the expanded definitions of securities contracts and repurchase agreements further the underlying policies of the safe harbors.³⁷⁴ For example, a committed mortgage loan repurchase agreement facility can function similarly to a conventional secured mortgage warehouse facility, but arguably qualify for protections under the safe harbors. In a typical mortgage warehouse transaction, the loan originator obtains short-term financing from a lender through a credit facility or similar arrangement secured by a pledge of mortgages or other assets owned by the originator (often to provide short-term financing until the mortgages can be deposited into a securitization pool). The originator can transfer or sell the mortgages or assets and would typically use any proceeds to pay down the facility with the lender.³⁷⁵ Such secured transactions do not, however, present the same contagion or market risks posed by true repurchase agreements and arguably fall outside the scope of the safe harbors.

Moreover, commentators robustly debate the ongoing utility of safe harbors for repurchase agreements covering mortgage loans and nonagency mortgage-backed securities. Some commentators argue that mortgage loan repurchase agreements should no longer be protected by the safe harbors.³⁷⁶ These commentators have called for excluding mortgage interests and mortgage-related transactions from the definitions of repurchase agreements and securities agreements. They assert, among other things, that mortgages are illiquid assets and therefore fall outside the justification for safe harbor protection (*i.e.*, “preservation of the liquidity of investments”).³⁷⁷ Others support maintaining broad protection for repurchase agreements, including mortgage repurchase agreements, based on the interconnectedness of the markets and the increasing importance of repurchase agreements in both domestic and global

³⁷⁰ See *id.*

³⁷¹ 11 U.S.C. § 741(7).

³⁷² *Id.* § 101(47).

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

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

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

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

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

investment portfolios.³⁷⁸ With respect to repurchase agreements specifically, these supporters believe that the protections afforded to such contracts by the safe harbors reduce the cost of credit and support domestic real estate markets.³⁷⁹ These supporters also suggest that any restrictions on investment in mortgage loans by financial institutions are best implemented through carefully considered prudential regulation rather than through the “blunt instrument” of a change to the Bankruptcy Code’s safe harbors. Both sides rely on anecdotal evidence to support their respective positions.

Treatment of Repurchase Agreements Under Safe Harbors: Recommendations and Findings

Repurchase agreements as financial instruments provide liquidity and flexibility to market participants. They also represent a large component of the financial markets.³⁸⁰ The Commissioners recognized the important role that repurchase agreements play in the markets, particularly those initiated on an overnight or short-term basis. Some of the Commissioners agreed with those commentators who distinguish mortgage loan repurchase agreements from other kinds of repurchase agreements structured around more liquid assets such as U.S. government and agency securities. The ability to liquidate the transferred assets immediately upon a default is a central and important feature of traditional repurchase agreements.

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

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

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

380 Data as of June 2014 suggest that the value of outstanding repurchase agreements in the United States is approximately \$4 trillion. See Elizabeth Holmquist & Josh Gallin, *Repurchase Agreements in Financial Accounts of the United States*, June 30, 2014, available at <http://www.federalreserve.gov/econresdata/notes/feds-notes/2014/repurchase-agreements-in-the-financial-accounts-of-the-united-states-20140630.html>.

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

382 Between 1994 and 2006, the Bankruptcy Code had defined “securities contract” as follows:

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

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

3. Assumption of Financial Contracts

Recommended Principles:

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

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

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

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

Assumption of Financial Contracts: Background

One consequence of the safe harbors is that counterparties can liquidate and close out qualified financial contracts with the debtor in possession, even if the debtor in possession's³⁸³ positions under those contracts are in the money or the debtor in possession may be able to continue to perform or assign the contracts.³⁸⁴ As explained above, counterparties to qualified financial contracts generally are not subject to the automatic stay under section 362 and the prohibition on *ipso facto* clauses under section 365(e). These exceptions almost always preclude a debtor in possession's ability to assume or assign qualified financial contracts because the contracts are terminated, liquidated, or accelerated on the debtor in possession's petition date or shortly thereafter.³⁸⁵

Some commentators have argued against this result and in favor of a short stay that would allow the debtor in possession some ability to assume or assign some or all of its qualified financial contracts.³⁸⁶ This approach would be similar to that provided for systemically important financial institutions under the Orderly Liquidation Authority (“OLA”), Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.³⁸⁷ Under OLA, counterparties are enjoined for one business day from terminating, liquidating, or accelerating their positions under qualified financial contracts.³⁸⁸ Likewise, under different pieces of legislation proposed in Congress to address systemically important financial institutions under federal bankruptcy law, counterparties would be subject to a 48-hour stay before they could exercise any of their rights.³⁸⁹ Under OLA, the receiver is given a brief opportunity to assign the bank's qualified financial contracts (likely to a bridge or similar institution) to facilitate its resolution, provided that certain conditions are satisfied. In the case of the proposed Financial Institutions Bankruptcy Act, the debtor (a systemically important bank holding company) is given a brief opportunity to transfer the stock of its subsidiaries to a special trust under certain conditions, when the debtor's estate is the beneficial owner of such trust.³⁹⁰

Assumption of Financial Contracts: Recommendations and Findings

The Commission considered the potential utility of incorporating a short stay imposed on counterparties before they would be able to exercise their rights under qualified financial contracts against a debtor in possession upon the filing of its chapter 11 case. The Commissioners noted that this kind of short-term stay would primarily benefit the debtor in possession by allowing it to potentially (i) assume certain contracts when the debtor in possession is in the money or could continue to perform or (ii) assign such contracts to another entity. Although in theory both options

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

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

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

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

387 12 U.S.C. § 5390(c)(10)(B).

388 *Id.*

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

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

are appealing and hold potential value for the estate, the Commissioners questioned the ability of a debtor in possession to review its qualified financial contracts in such a meaningful and expeditious manner early in the chapter 11 case. They also raised concerns about structuring and funding a transaction early in the case in which the debtor in possession could effectively assign and transfer its qualified financial contracts. Many of the Commissioners also believed that, given the market stability and the systemic issues relating to these contracts, the debtor in possession would need to provide some type of adequate assurance to counterparties during the short-term stay, or otherwise compensate counterparties for any loss in value that they suffered while they were enjoined from exercising their rights under the contracts.

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

4. Section 562 and “Commercially Reasonable Determinants of Value”

Recommended Principles:

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

Section 562 and “Commercially Reasonable Determinants of Value”: Background

Section 562 of the Bankruptcy Code addresses the “timing of damage measurement” when a qualified financial contract is rejected by a trustee³⁹¹ or liquidated, terminated, or accelerated by a nondebtor counterparty.³⁹² As a general rule, section 562(a) provides that damages should be measured as of the earlier of the date when the trustee rejects the qualified financial contract or the date when the nondebtor counterparty liquidates, terminates, or accelerates the qualified financial contract. If no

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

³⁹² 11 U.S.C. § 562.

commercially reasonable determinants of value exist on that date, however, section 562(b) provides that damages should be measured as soon as commercially reasonable determinants of value are available.³⁹³ Accordingly, the meaning of the term “commercially reasonable determinants of value” may play a central role in measuring damages under qualified financial contracts.

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

Second, section 562 does not address the methodology to be used in calculating damages. Specifically, it is uncertain whether parties must adhere to a valuation methodology established by their contract or if they may use an alternative methodology provided that it is commercially reasonable under the circumstances. The importance of this decision becomes more acute if commercially reasonable determinants of value for purposes of the methodology required by the contract do not exist on a particular date, but the assets could be valued as of that date under another commercially reasonable methodology.

Section 562 and “Commercially Reasonable Determinants of Value”: Recommendations and Findings

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

³⁹³ The legislative history of section 562 provides:

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

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

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

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

5. Walkaway Clauses

Recommended Principles:

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

Walkaway Clauses: Background

In general, the terms "one-way payment," "limited two-way payment," and "walkaway" refer to provisions in qualified financial contracts that, upon termination, liquidation or acceleration of a particular transaction by the nondefaulting party, based on a default by the counterparty, eliminate the benefit of the contract to the defaulting counterparty even if the contract is in the money for that counterparty. The Bankruptcy Code does not specifically address walkaway clauses, other than in the context of repurchase agreements under section 559.³⁹⁵ Yet, these provisions can significantly impact the estate's rights under qualified financial contracts if the debtor is deemed to be the defaulting party at the time of the rejection, termination, liquidation, or acceleration of the contract. For example, pursuant to a walkaway clause, a defaulting party is generally not entitled to any payments that are otherwise owed to it under the qualified financial contract (for example, if the debtor's position is in the money at the time of the triggering event). Alternatively, the defaulting party may only be permitted to use its right to any payments to offset amounts it owes to the nondefaulting party.

Notably, other laws specifically prohibit the enforcement of walkaway clauses. The Federal Deposit Insurance Act includes provisions that make walkaway clauses in qualified financial contracts of depository institutions that are in default unenforceable.³⁹⁶ The Orderly Liquidation Authority, which is a resolution regime that could apply to systemically important financial institutions, also renders

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

³⁹⁶ 12 U.S.C. § 1821(e)(8)(G)(i).

walkaway clauses unenforceable.³⁹⁷ In addition, the Insurer Receivership Model Act, which is a model insurer insolvency act promulgated by the National Conference of Insurer Commissioners, renders walkaway clauses unenforceable in qualified financial contracts against an insurer undergoing insolvency proceedings that is deemed to be the defaulting party.³⁹⁸

Walkaway Clauses: Recommendations and Findings

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

6. Exclusion of “Ordinary Supply Contracts” from Safe Harbors

Recommended Principles:

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

Exclusion of “Ordinary Supply Contracts” from Safe Harbors: Background

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

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

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

³⁹⁸ Model Insurer Receivership Act § 711.

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

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

Consequently, parties have argued and some courts have held that ordinary supply agreements constitute protected qualified financial contracts under the Bankruptcy Code safe harbors.⁴⁰³ As the Fifth Circuit explained, courts must “apply the statutory provisions as Congress wrote them,” and it found no grounds for excluding the electricity requirements contract from the Bankruptcy Code’s definition of forward contracts.⁴⁰⁴

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

Congress determined that there are legitimate reasons for creating, in the financial markets, these special exceptions to the overall protections and policies of the Code. The court understands that if contracts traded on a financial market are unraveled, the market itself could become unstable and a domino effect could occur. There is nothing to suggest that the contract between Smithfield and the debtor was traded on a financial market, so in this case only the debtor’s estate and Smithfield would be affected by a recovery. There is no reason to disturb the established ability of the trustee to avoid the alleged fraudulent transfers at issue in this case.

The consequences of including agreements such as the one before the court within the definition of swap agreement would be far-reaching. . . . These exceptions to the trustee’s avoidance powers were intended to avoid the greater danger of market disruption and instability in the financial markets due to the domino effect likely as

400 11 U.S.C. § 101(25).

401 *Id.* § 761(4).

402 *Id.* § 101(53B).

403 See, e.g., *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs., Inc.)*, 690 F.3d 352 (5th Cir. 2012); (5th Cir. Aug. 2, 2012) (characterizing electric requirements contracts as forward contracts under the Bankruptcy Code); *In re Nat’l Gas Distribs., LLC*, 556 F.3d 247 (4th Cir. 2009) (finding that natural gas supply contract could constitute a commodities forward contract and, as such, a swap agreement under the Bankruptcy Code).

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

a result of some types of transfer avoidance. Congress certainly did not intend by the amendment to create a new, equally disruptive ripple effect within the administration of bankruptcy estates. The court must take into consideration the effect its decision will have on the overall scheme of the Bankruptcy Code. If this agreement is a swap agreement, then many of the most important aspects of the Code, including priorities of distributions to creditors and the automatic stay, will be eviscerated in even the smallest case of a farmer who contracts to sell his hogs at the end of the month for a set price. No public purpose would be served, and the result would be wholly at odds with the established aims and order of bankruptcy proceedings. . . .⁴⁰⁵

Exclusion of “Ordinary Supply Contracts” from Safe Harbors: Recommendations and Findings

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

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

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

In discussing the scope of qualified financial contracts, several Commissioners noted the need to critically analyze any exceptions to, or priorities created by, the Bankruptcy Code.⁴⁰⁶ These

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

⁴⁰⁶ See, e.g., *Howard Delivery Service, Inc. v. Zurich Am. Ins. Co.*, 547 U.S. 651, 667 (2006) (noting that the Court was “guided in reaching [its] decision by the equal distribution objective underlying the Bankruptcy Code, and the corollary principle that provisions allowing preferences must be tightly construed.”); *Trustees of Amalgamated Ins. Fund v. McFarlin’s, Inc.*, 789 F.2d 98, 100 (2d Cir. 1986) (“Because the presumption in bankruptcy cases is that the debtor’s limited resources will be equally distributed among his creditors, statutory priorities are narrowly construed.”). See also *Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (“These changes reflect a pervasive trend away from the fundamental concept of equality for similarly situated creditors

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Commissioners reiterated the importance of the policies underlying the Bankruptcy Code, including a breathing period for the debtor, a level playing field among the debtor and its stakeholders, and fair treatment of all similarly situated creditors, in facilitating a successful reorganization.⁴⁰⁷ For example, if all or a substantial majority of a debtor's contracts could be terminated by the nondebtor parties, or most creditors were entitled to priority payments or protected from avoidance actions, the utility of chapter 11 would be significantly reduced, if not eliminated.

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

in bankruptcy and, in the aggregate, make it harder for a company to reorganize. As such, MFA urges the Commission to take a fresh look at the existing categories of preferred creditors, and to strongly oppose any proposals that would create additional priority categories or other preferential treatment for particular creditor groups.”).

⁴⁰⁷ Numerous courts have held that “it is the clear policy of the Bankruptcy Code to provide the debtor with breathing space following the filing of a bankruptcy petition, continuing until the confirmation of a plan, in which to assume or reject an executory contract.” *In re Adelphia Commc'ns Corp.*, 291 B.R. 283, 292 (Bankr. S.D.N.Y. 2003) (citations omitted). *See also* *Theatre Holding Corp. v. Mauro*, 681 F.2d 102, 105–06 (2d Cir. 1982); *In re Enron Corp.*, 279 B.R. 695, 702 n.8 (Bankr. S.D.N.Y. 2002); *In re Teligent, Inc.*, 268 B.R. 723, 738 (Bankr. S.D.N.Y. 2001); *In re Beker Indus. Corp.*, 64 B.R. 890, 897 (Bankr. S.D.N.Y. 1986). *But see In re Enron Corp.*, 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002) (noting that “the breathing space afforded to the debtor for the assumption or rejection of executory contract is not without limits.”).



V. PROPOSED RECOMMENDATIONS: ADMINISTERING THE CASE

A. Executory Contracts and Leases

Section 365 of the Bankruptcy Code generally allows a debtor in possession to assume, assign, or reject executory contracts and unexpired leases in the chapter 11 case.⁴⁰⁸ The debtor in possession typically makes this determination based on a variety of factors, including whether the contract or lease is above or below market, necessary to its ongoing business operations, and subject to assumption under the Bankruptcy Code. It also may consult with the unsecured creditors' committee on these issues or attempt to renegotiate the contract or lease with the nondebtor party. A debtor in possession's decision to assume, assign, or reject an executory contract or unexpired lease is subject to court approval, certain deadlines, and several other requirements detailed in section 365.⁴⁰⁹

1. Definition of Executory Contract

Recommended Principles:

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

Definition of Executory Contract: Background

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

Courts traditionally have used what is commonly referred to as the “Countryman” definition of executory contracts.⁴¹³ This test was developed by Professor Vern Countryman and defines an

408 11 U.S.C. § 365.

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

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

411 11 U.S.C. § 365(a).

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

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

executory contract for bankruptcy purposes as “a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.”⁴¹⁴ Although widely used, courts have recognized limitations and potential inconsistencies in the application of the Countryman test.⁴¹⁵ In addition, the test may not be a good fit for certain kinds of contracts.⁴¹⁶

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

Another alternative approach is commonly referred to as the “exclusionary approach.” This approach is a deviation from the Countryman test and was developed by Michael Andrew.⁴²⁰ The following are the primary differences between the Countryman test and the exclusionary approach: (i) the concept of executoryness is irrelevant in the rejection context;⁴²¹ and (ii) a contract is executory if each party has unperformed obligations, and if the debtor’s nonperformance eliminates its right

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

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

416 Some courts have struggled with the application of the Countryman definition in the context of the following kinds of agreements: options and rights of first refusal; restrictive covenants (covenants not to compete; restrictive covenants on land); oil and gas agreements (e.g., the oil and gas leases themselves and variations thereof, like farmout agreements, and related agreements, like surface use agreements and joint operating agreements); licenses, distributor agreements, and trademark agreements; warranties; rights of first refusal; employment contracts; and severance agreements; arbitration clauses; forum selection clauses; distributor agreements; trademark agreements; and indemnity clauses; and settlement agreements. See, e.g., *Water Ski Mania Estates Homeowners Ass’n v. Hayes (In re Hayes)*, 2008 Bankr. LEXIS 4668, at *31–32 (B.A.P. 9th Cir. Mar. 31, 2008) (“[A]lthough restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. Although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting § 365.”) (citation omitted); *Frontier Energy, LLC v. Aurora Energy, Ltd. (In re Aurora Oil & Gas Corp.)*, 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) (“The court’s conclusion that the [oil and gas leases] qualify as ‘leases’ within the meaning of Section 365 makes it unnecessary to consider whether the [oil and gas leases] meet either the functional test or Countryman definition for executory contracts. Given the confusion in the case law, it is also improvident to opine on the question.”) (citations omitted); *In re Bergt*, 241 B.R. 17, 29–31 (Bankr. D. Alaska 1999) (discussing the application of the Countryman test in recent case law to options); *Bronner v. Chenoweth-Massie, P’ship (In re Nat’l Fin. Realty Trust)*, 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998) (“The contingent nature of the obligations arising from an option agreement make them quite distinguishable from the typical contract. This distinction has puzzled many courts, resulting in two distinct lines of cases. The first line of cases, while recognizing the contingent nature of the obligations arising under option agreements, and while also expressly acknowledging that they are unilateral contracts until exercised, have nevertheless engaged in what could be described as analytical gymnasts to arrive at a finding that they are nonetheless executory contracts.”) (citations omitted); *Cohen v. Drexel Burnham Lambert Grp., Inc. (In re Drexel Burnham Lambert Grp., Inc.)*, 138 B.R. 687, 699 (Bankr. S.D.N.Y. 1992) (“Our readings persuade us that in each case, use of the Countryman test was neither necessary nor determinative. It was, rather, merely window dressing for results determined in the first instance by resort to another, sometimes unspecified criterion.”) (analyzing case law regarding application of Countryman test to employment agreements). See also *infra* note 424.

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

418 *Id.* at 287.

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

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

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

to the other party's performance.⁴²² Although courts have not adopted this approach, they have considered its factors in applying other tests.⁴²³

Definition of Executory Contract: Recommendations and Findings

The Commission conducted an in-depth review of the literature and case law on executoryness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoryness issue and the attendant uncertainty and expense. The focus of the executoryness inquiry is whether each party has significant unperformed obligations under the contract.⁴²⁴ The Commissioners discussed examples of contracts when this issue may be of particular concern, such as options, covenants not to compete, and oil and gas leases.⁴²⁵ Although executoryness is not necessarily a bright-line determination, the Commissioners generally agreed that courts resolve this issue fairly or parties are able to negotiate a resolution.

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

Further deliberations about the elimination proposal revealed, however, the potential of unintended consequences of such a dramatic shift in a fundamental bankruptcy principle. The Commissioners noted the common law origins of the executoryness requirement of section 365,⁴²⁷ and they also

422 *Id.* at 893.

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

424 The Seventh Circuit Court of Appeals explained:

The Bankruptcy Code's legislative history states that the term "executory contract" "generally includes contracts on which performance is due to some extent on both sides." A common definition, which this court has cited with approval, states that a contract is executory for bankruptcy purposes where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material breach excusing the performance of the other."

In re Crippin, 877 F.2d 594, 596 (7th Cir. 1989). See also *Counties Contracting & Constr. Co. v. Constitution Life Ins. Co.*, 855 F.2d 1054, 1060 (3d Cir. 1988) ("The [Bankruptcy] Code does not define the term executory contract, however, courts have generally employed what has become known as the 'Countryman' definition of an executory contract, *i.e.*, a contract under which the obligations of both the bankrupt and the other party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation omitted).

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

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

427 See *In re Austin Dev. Co.*, 19 F.3d 1077, 1081 (5th Cir. 1994) ("Section 365 derives from § 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's

perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executory concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.

The Commissioners also discussed the functional approach to determining executory, but most perceived the test to be unfair toward counterparties and too heavily weighted in favor of the interests of the debtor and the estate. The Commissioners acknowledged the potential value of allowing a debtor in possession to assume or reject any contract that would provide a benefit to the estate. As with the elimination proposal, however, the Commissioners were concerned about diminishing the rights of the nondebtor counterparties under the contracts. Subjecting any contract to section 365 primarily, if not solely, for the benefit of the estate imposed a greater burden on nondebtor parties than necessary to achieve a fair result for the estate in a chapter 11 case.

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

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

Recommended Principles:

- A nondebtor party to an executory contract or unexpired lease with the debtor should be required to continue to perform under such contract or lease after the petition date, provided that the trustee needs such continued performance and pays for any products or services delivered after the petition date on a timely basis as required by the contract or lease. In paying for such products or services, however, the trustee should not be subject to any modifications or rate changes in the contract or lease triggered by the debtor's bankruptcy filing, insolvency, or prepetition default.
- Except as provided in section 365(d)(3) of the Bankruptcy Code (and the principles for that section, *see* Section V.A.6, *Real Property Leases*) and in section 365(d)(5) of the Bankruptcy Code, the trustee does not otherwise have an

leases or executory contracts or to 'reject' them if they were economically burdensome to the estate.”).

obligation to perform, or to cure any defaults, under such contract or lease prior to the assumption of that contract or lease under section 365(a). The nondebtor party should be permitted to compel the trustee to perform other postpetition obligations under the contract or lease if the court determines, after notice and a hearing, that the harm to the nondebtor party resulting from the trustee's nonperformance significantly outweighs the benefit to the estate derived from such nonperformance. The court should limit the trustee's performance obligation to that which is necessary to mitigate the harm to the nondebtor party pending assumption or rejection. The nondebtor party should bear the burden of proof in any such hearing.

- The trustee should not be required to cure nonmonetary defaults that occur prior to the assumption of the executory contract or unexpired lease and that are impossible for the debtor to cure at the time of the proposed assumption under section 365(a) and (b).
- These principles governing the rights of parties to executory contracts and unexpired leases are intended to apply only to contracts and leases between private parties and should not affect the debtor's contracts or leases with any state or federal governments.

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Background

In most chapter 11 cases, the debtor in possession⁴²⁸ does not make its decision to assume, assign, or reject executory contracts and unexpired leases on, or even shortly after, the petition date. As such, there is a gap period between the petition date and the treatment decision under section 365. The Bankruptcy Code requires the debtor in possession to perform timely obligations arising under nonresidential real property leases, certain personal property leases,⁴²⁹ and intellectual property licenses,⁴³⁰ but does not otherwise address performance during the gap period.⁴³¹ In light of this silence, “most courts agree that before an executory contract is assumed or rejected under § 365(a), that contract continues to exist, enforceable by the debtor in possession, but not enforceable against the debtor in possession.”⁴³²

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

429 11 U.S.C. § 365(d)(5). This provision for personal property leases applies only in chapter 11 cases. *Id.* If the case is initially filed under chapter 11 and later converted to chapter 7, section 365(d)(5) will no longer apply. 3 Collier on Bankruptcy ¶ 365.04[2][c].

430 11 U.S.C. § 365(n).

431 *Id.* § 365(d)(3). The court “may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period” *Id.*

432 See, e.g., *In re Nat'l Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (collecting cases). See also Howard C. Buschman III, *Benefits and Burdens: Postpetition Performance of Unassumed Executory Contracts*, 5 Bankr. Dev. J. 341, 343 (1988) (citing Douglas Bordewick & Vern Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors*, 57 Am. Bankr. L.J. 239, 332 (1983)); 2 Collier on Bankruptcy ¶ 365.03, 365-28, 365-29 (15th ed. 1988); 8 Collier on Bankruptcy ¶ 3.15(6) at 204 (14th ed. 1978).

Courts generally justify this one-sided performance requirement by emphasizing the importance of the breathing spell created by the automatic stay for the debtor in possession,⁴³³ and the severe consequences that may result from a rushed or premature decision to assume, assign, or reject an executory contract or unexpired lease.⁴³⁴ They also acknowledge the burden such one-sided performance may impose on the nondebtor party, but on balance find in favor of the estate. The nondebtor party may seek to compel performance or a treatment decision by the debtor in possession under section 365, and it frequently requests an administrative claim under section 503(b)(3) for any postpetition obligations that the debtor in possession fails to perform.⁴³⁵

Once a debtor in possession decides to assume an executory contract or unexpired lease, section 365(b) requires the debtor in possession to cure or provide adequate assurance of a prompt cure of any defaults under the contract or lease. Section 365(b)(1) indicates that nonmonetary defaults that are impossible to cure under unexpired leases for nonresidential real property do not require cure, “except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph.”⁴³⁶ Section 365(b)(2) further provides that a debtor in possession’s general cure obligations under section 365(b)(1) do not apply to “the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease.”⁴³⁷ Some courts have interpreted section 365 to preclude the assumption of executory contracts and unexpired leases (other than real property leases) if non-curable historical nonmonetary defaults exist under the contract or lease.⁴³⁸

General Rights of Private Parties to Executory Contracts and Unexpired Leases: Recommendations and Findings

The chapter 11 filing can have significant negative implications for a nondebtor party’s business. Accordingly, the Commission carefully scrutinized the postpetition needs of a debtor in possession with respect to executory contracts and unexpired leases. The Commissioners discussed the importance of a reliable, steady supply of goods and services used in the debtor’s business to the debtor in possession’s reorganization efforts. They also acknowledged that nondebtor parties frequently threaten to stop providing goods or services unless the debtor in possession satisfies certain conditions. Although the Commissioners understood the nondebtor party’s desire for more

433 See, e.g., *In re Cont’l Energy Assocs. Ltd. P’ship*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) (“Not only does this saddle an ailing company with an additional burden which it is unlikely to overcome, it pressures the Debtor to surrender the ‘breathing space’ normally allowed to it to consider the assumption or rejection of the contract.”).

434 11 U.S.C. § 365(g)(2). Post-assumption rejection is treated as a breach at the time of rejection (*i.e.*, postpetition). *Id.* Where a contract or lease is assumed in a chapter 11 case that is later converted to a chapter 7 and then the contract or lease is rejected in the chapter 7 case, the rejection would be treated as having occurred immediately before the date of conversion. 1 Collier Handbook for Trustees & Debtors in Possession ¶ 14.07 (2012).

435 11 U.S.C. § 503(b). The extent of the nondebtor party’s administrative claim, however, may be limited by the court under the “benefit to the estate” standard of section 503(b). See *Mason v. Official Comm. of Unsecured Creditors (In re FBI Distrib. Corp.)*, 330 F.3d 36, 42–43 (1st Cir. 2003) (“[T]he nondebtor party will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate.”); *In re Nat’l Steel Corp.*, 316 B.R. 287, 301 (Bankr. N.D. Ill. 2004) (“Claims under § 503(b)(1)(A) are to be measured by the benefit received by the estate rather than the cost incurred by a claimant.”).

436 11 U.S.C. § 365(b)(1).

437 *Id.* § 365(b)(2).

438 See, e.g., *In re Carterhouse, Inc.*, 94 B.R. 271, 273 (Bankr. D. Conn. 1988) (holding that section 365(b)(1) “extends to nonmonetary as well as monetary breaches”).

certainty and for some kind of adequate assurance, they found the general principles underlying the postpetition performance requirements to be sound.

Reflecting on the circumstances of nondebtor parties in these cases, however, the Commissioners considered various ways to mitigate the burden imposed by the general postpetition performance requirement. They did not believe that the debtor in possession should be required to provide adequate protection under section 361 of the Bankruptcy Code or to cure any historical defaults prior to assumption or rejection of the contract or lease. They also rejected full performance of the contract or lease by the debtor in possession, agreeing with courts that hold such a requirement undercuts the value of the automatic stay in the debtor in possession's reorganization efforts.

The Commissioners debated the feasibility of requiring the debtor in possession to pay for goods and services actually provided to the debtor in possession postpetition in accordance with the terms of the contract or lease. Some Commissioners commented that the debtor in possession may not have the liquidity to meet this standard on an immediate postpetition basis, while others indicated that the debtor in possession's needs in this respect could be factored into the postpetition financing budget.⁴³⁹ The Commissioners stressed the need for any such payment obligation to be limited to those goods and services needed by, and provided to, the debtor in possession postpetition and that the nondebtor party should not be able to enforce more onerous payment terms from, or demand any other type of performance of, the debtor in possession pending assumption or rejection of the contract or lease.⁴⁴⁰ The terms of the prepetition contract or lease should govern the timing and amount of the debtor in possession's postpetition payment obligations, unless the parties mutually agree to more beneficial terms for the estate.

The Commissioners also analyzed the circumstances under which nondebtor parties should be able to seek to compel full or greater postpetition performance by the debtor in possession under the contract or lease. The Commissioners generally believed that nondebtor parties should have this option, but that the standard of proof should be stringent and that the nondebtor party should bear the burden of proof, particularly in light of the Commission's recommendation to require some postpetition payment by the debtor in possession. The Commission ultimately determined that this standard was an appropriate balance and recommended the joint proposal of requiring payment solely for goods or services provided to the debtor in possession postpetition and placing a high evidentiary burden on the nondebtor party that seeks to compel further or other postpetition performance. The Commissioners also discussed the potential impact of these provisions on government contracts. In light of the different and varied interests that may be implicated by government contracts, the Commission agreed that these contracts be excluded from the recommended principles governing postpetition performance of executory contracts and unexpired leases and that such principles be limited to the rights of private parties to executory contracts and unexpired leases with a debtor.

439 Some of the Commissioners proposed incorporating an "adequate assurance" concept similar to Section 2-609 of the Uniform Commercial Code, but others believed that this would provide too much leverage for counterparties in terms of holdup value.

440 *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (June 4, 2013) (stating that retailers are failing because of the reluctance of trade creditors to extend credit on reasonable terms and the difficulty of obtaining DIP and exit financing to support reorganization), available at Commission website, *supra* note 55; *id.* at 5 (citing the January 2013 Senior Loan Officer Opinion Survey on Bank Practices from the Federal Reserve which indicates that DIP lending is tight and trade vendors are unwilling to extend credit except on onerous terms).

Finally, the Commissioners addressed the continued confusion in the case law concerning a debtor in possession's obligation to cure historical nonmonetary defaults in order to assume the executory contract or unexpired lease. The Commissioners acknowledged that the BAPCPA Amendments to the Bankruptcy Code clarified this issue for real property leases, but that ambiguity remained for other kinds of leases and executory contracts. The Commissioners debated whether certain kinds of historical nonmonetary defaults were so central to a contract's or lease's purpose that their nonperformance should bar assumption. On balance, the Commission determined that, with respect to all executory contracts and unexpired leases, a debtor in possession should not be required to cure nonmonetary defaults occurring prior to the assumption decision that are impossible to cure at the time of assumption under section 365(b) of the Bankruptcy Code.

3. Rejection of Executory Contracts and Unexpired Leases

Recommended Principles:

- The rejection of an executory contract or unexpired lease should continue to constitute a breach of the contract or lease as of the time immediately preceding the commencement of the case under section 365(g) of the Bankruptcy Code. The trustee's rejection of an executory contract or unexpired lease should not, however, entitle the nonbreaching, nondebtor party to a right of specific performance or to retain possession or use of any property of the debtor or the estate.
- A nonbreaching, nondebtor party should be able to retain possession or continue to use property of the debtor or the estate if expressly authorized by a section of the Bankruptcy Code (*e.g.*, section 365(n)).
- If the nondebtor party to an executory contract or unexpired lease breaches the executory contract or unexpired lease prior to the trustee's assumption or rejection decision, the trustee may treat such contract or lease as breached and exercise any rights or remedies it may have under the contract or lease or applicable nonbankruptcy law.

Rejection of Executory Contracts and Unexpired Leases: Background

A debtor in possession⁴⁴¹ may reject (*i.e.*, disavow) most executory contracts and unexpired leases under section 365(a) of the Bankruptcy Code. A debtor in possession's decision to reject an executory contract or unexpired lease generally relieves the debtor in possession of further performance obligations under the contract or lease. Courts, however, have differed on whether rejection terminates the contract or lease or, rather, constitutes a breach by the debtor in possession of such contract or lease.

⁴⁴¹ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

Section 365(g) of the Bankruptcy Code specifically provides that rejection “constitutes a breach of such contract or lease.” As such, section 365(g) answers the initial question concerning the effect of rejection and expressly equates rejection with a breach of the contract or lease by the debtor.⁴⁴² In some cases, that determination may end the inquiry, but in other cases, questions still remain regarding what rights the nondebtor party may pursue under the contract or lease or under applicable nonbankruptcy law because of the debtor’s breach. As explained by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,

[w]hat § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party’s rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. . . . The debtor’s unfulfilled obligations are converted to damages; . . . But nothing about this process implies that any rights of the other contracting party have been vaporized.⁴⁴³

Courts and commentators agree that rejection gives the nondebtor party a right to assert monetary damages against the debtor in possession, which is deemed a prepetition claim against the estate.⁴⁴⁴ They also generally agree that the nondebtor party cannot compel continued performance by the debtor in possession, unless otherwise specifically permitted by section 365.⁴⁴⁵ They do not, however, agree whether the nondebtor party can enforce equitable remedies against the debtor in possession that such party otherwise would be able to assert under applicable nonbankruptcy law.⁴⁴⁶ The court’s perspective on this issue can have significant implications for the estate.

Rejection of Executory Contracts and Unexpired Leases: Recommendations and Findings

The Commission focused a substantial amount of time on the concept of rejection and whether a debtor in possession’s decision to reject an executory contract or unexpired lease should trigger a breach or termination of such contract or lease. The Commissioners discussed the language of section 365 and specifically contrasted it with the chapter 5 avoiding powers of the debtor in possession. Congress did not intend section 365 to operate as an avoiding power that would allow a debtor in possession to terminate or unwind prepetition agreements or completely extinguish the rights of the nondebtor counterparty to an agreement. Such a result would be contrary to the language and structure of the Bankruptcy Code and well-settled federal policy that state law generally determines

⁴⁴² See, e.g., *Sunbeam Prod., Inc. v. Chi. Am. Mfg. LLC*, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012). Both the National Bankruptcy Conference’s Bankruptcy Code Review Project in 1993 and the NBRC in 1997 expressly considered the question of whether rejection should result in termination and provided a negative answer. A.L.I.-A.B.A., *Bankruptcy Reform* Circa 1993 183–87 (Nat’l Bankr. Conf. 1993); NBRC Report, *supra* note 37, § 2.4.1.

⁴⁴³ *Sunbeam Prod., Inc. v. Chi. Am. Mfg. LLC*, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012).

⁴⁴⁴ 11 U.S.C. § 365(g)(1).

⁴⁴⁵ See, e.g., *In re Walnut Assocs.*, 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992) (“[N]on-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor’s general unsecured creditors. . . . [U]nless specific performance is available to the non-debtor party under applicable state law, the debtor cannot be compelled to render its performances required under the contract. However, if state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.”).

⁴⁴⁶ See, e.g., *Abboud v. Ground Round, Inc. (In re Ground Round, Inc.)*, 335 B.R. 253 (B.A.P. 1st Cir. 2005) (“[A] party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under applicable state law.”); *In re Annabel*, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (same with respect to covenant not to compete). *But see, e.g., In re Register*, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989) (refusing to enforce covenant not to compete in rejected sale agreement). See also *Route 21 Assoc. of Belleville, Inc. v. MHC, Inc.*, 486 B.R. 75 (S.D.N.Y. 2012) (injunctive relief could be reduced to monetary claim).

property rights in bankruptcy.⁴⁴⁷ The Commission voted to reinforce the principle that rejection of an executory contract or unexpired lease constitutes a breach, not a termination, of such contract or lease.

The Commissioners fully vetted the potential consequences of equating rejection with breach of the applicable contract or lease, using various examples to explore the nuances and variances in possible results. In analyzing these scenarios, the Commissioners worked to balance the state law rights and interests of the nondebtor party with the federal interests that are central to the reorganization efforts of a debtor in possession. These federal interests include equal treatment of all similarly situated creditors, automatic stay of actions based on prepetition transactions and relationships with the debtor, and the ability of the debtor in possession to reject burdensome contracts and leases to facilitate its reorganization.⁴⁴⁸

The Commission considered the rejection of different kinds of contracts and leases, and identified the competing interests of the debtor in possession and the nondebtor, and the needs of the estate, following rejection. For example, the debtor in possession, on behalf of the estate, needs (i) any property that may be held by the nondebtor party to be returned; (ii) the ability to use such property free from restraints or limitations; and (iii) relief from any performance obligations under the contract or lease. Congress was aware of these needs and carefully balanced them against the interests of the nondebtor party. In specific instances when the interests of the nondebtor party outweigh the needs of the debtor in possession, Congress specified the nondebtor party's rights upon rejection. Specifically, these exceptions arise in the context of certain real property leases, timeshares, and intellectual property licenses.⁴⁴⁹

The Commission agreed that, other than the exceptions already made by Congress, the nondebtor party to the rejected contract or lease should be required to immediately return the debtor's property to the debtor in possession and should not be able to enforce any equitable or injunctive relief against, or otherwise require performance by, the debtor in possession. In addition to the factors previously noted, the Commissioners pointed to section 542 in support of requiring the counterparty to return personal property to the estate upon rejection.⁴⁵⁰ They also believed that allowing the nondebtor party to enforce equitable or injunctive relief against the debtor in possession would elevate the rights of such counterparty beyond those of other similarly situated prepetition creditors. Indeed, general unsecured creditors typically are not entitled to relief from the automatic stay or to take actions affecting the debtor in possession's postpetition business operations, despite the terms of the creditors' prepetition contracts or applicable nonbankruptcy law. Accordingly, the Commission

447 "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Butner v. United States*, 440 U.S. 48, 54 (1979).

448 See, e.g., *In re Am. Suzuki Motor Corp.*, 494 B.R. 466, 477 (Bankr. C.D. Cal. 2013) ("The purpose of contract rejection under section 365 is to permit the debtor to receive the economic benefits necessary for reorganization (which includes liquidation under chapter 11) for the ultimate benefit of the estate and its creditors. State legislatively imposed buyback requirements, fair market value awards and treble-damages penalties are superimposed onto the normal contract damage remedy provisions under state common or statutory law. While Florida and many other states believe that their public policy should provide special protections for the economic interest of local car dealerships, in the area of federal bankruptcy law those remedies run counter to the federal policy of bankruptcy reorganization and are therefore preempted."); *In re PPI Enters. (U.S.), Inc.*, 228 B.R. 339, 344–45 (Bankr. D. Del. 1998) ("In enacting the Bankruptcy Code, Congress made a determination that an eligible debtor should have the opportunity to avail itself of a number of Code provisions which adversely alter creditors' contractual and nonbankruptcy law rights.").

449 11 U.S.C. § 365(h), (i), (n).

450 *Id.* § 542(a) ("[A]n entity . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.").

endorsed the conclusions that rejection should constitute a breach, but it should not (i) deprive the debtor in possession of the right to possess or use estate property or (ii) require specific performance by the debtor in possession or the estate.

4. Intellectual Property Licenses

Recommended Principles:

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.
- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.
- Foreign patents and copyrights should be included within the definition of “*intellectual property*” set forth in section 101(35A) and subject to section 365, including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on domestic trademarks under the recommended principles in Section V.A.5, *Trademark Licenses*.

Intellectual Property Licenses: Background

A debtor’s or the estate’s assets often include intellectual property. The Bankruptcy Code defines “*intellectual property*” as a “(A) trade secret; (B) invention, process, design, or plant protected under title 35 [of the U.S. Code]; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [of the U.S. Code]; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law.”⁴⁵¹ In the context of section 365 of the Bankruptcy Code, debtors in possession⁴⁵² commonly face issues with respect to their ability to assume, assign, or reject their intellectual property licenses.⁴⁵³

⁴⁵¹ 11 U.S.C. § 101(35A).

⁴⁵² As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁴⁵³ Courts generally characterize intellectual property licenses as executory contracts. *In re Kmart Corp.*, 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) (“Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy

A “*license*” is an agreement that generally allows an owner to monetize the value of its intellectual property. Licenses permit, often for a fee, a third party (licensee) to use the owner’s (licensor’s) intellectual property for a specified purpose, within a specified geographic region, for a specified time period, under specified conditions. Licenses range on a sliding scale from conferring very limited nonexclusive rights to all or essentially all rights to the intellectual property. Licenses are, in essence, a form of covenant by which the licensor agrees not to sue the licensee for using the licensor’s intellectual property.

When a debtor in possession is the licensee under an intellectual property license, two potentially competing federal interests are at play: (i) the Bankruptcy Code generally allows the debtor in possession to unilaterally decide whether to assume, assign, or reject an executory contract; and (ii) the federal law on intellectual property licenses respects the right of the licensor to control its intellectual property.⁴⁵⁴ Some courts have turned to section 365(c) of the Bankruptcy Code to address this potential conflict. Section 365(c) generally restricts the ability of a debtor in possession to assume or assign if “applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties.”⁴⁵⁵ Such contracts can be assumed or assigned by the debtor in possession only with the consent of the nondebtor party to the contract.

Courts applying section 365(c)(1) to the rights of a debtor in possession as a licensee under an intellectual property license are split regarding whether a debtor in possession may assume (*i.e.*, keep and perform under) the license, as opposed to assigning the license to a third party, without the consent of the nondebtor licensor. Courts that permit a debtor in possession to assume a license under these circumstances follow the “actual approach,” which treats the debtor in possession as the same entity to which the third party licensor extended the license in the first instance.⁴⁵⁶ Because the identity of the parties has not changed under this theory and the action would not be deemed an impermissible assignment under applicable nonbankruptcy law, these courts authorize the debtor in possession to assume such license under section 365(a) and (b).

Other courts, however, find the actual test in contravention of the statutory language. These courts follow the “hypothetical approach,” which preclude the debtor in possession from assuming an agreement if applicable nonbankruptcy law would preclude the debtor from assigning the license to a third party, even if the debtor in possession has no intention of effecting such an assignment.⁴⁵⁷ Some commentators have criticized the hypothetical approach as providing the nondebtor licensor

Code.”) (citations omitted).

454 See *Unarco Indus., Inc. v. Kelley Co., Inc.*, 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (citations omitted) (“[L]ong standing federal rule of law with respect to the assignability of patent licenses provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement.”).

455 11 U.S.C. § 365(c)(1).

456 The First and Fifth Circuits adopted the “actual test.” *In re Mirant Corp.*, 440 F.3d 238 (5th Cir. 2006); *Institut Pasteur v. Cambridge Biotech Corp.*, 104 F.3d 489 (1st Cir. 1997), *abrogated by* *Hardemon v. City of Boston*, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998). See also *In re Footstar, Inc.*, 323 B.R. 566 (Bankr. S.D.N.Y. 2005) (taking a slightly different approach but holding that section 365(c)(1)’s use of the word “trustee” does not include the debtor or debtor in possession when assumption is sought because assumption does not require the nondebtor party to accept performance from a new party other than the debtor or debtor in possession).

457 The Third, Fourth, Ninth, and Eleventh Circuits have adopted the “hypothetical test.” *In re Sunterra Corp.*, 361 F.3d 257 (4th Cir. 2004); *In re Catapult Entm’t, Inc.*, 165 F.3d 747 (9th Cir. 1999); *In re James Cable Partners, L.P.*, 27 F.3d 534 (11th Cir. 1994); *In re West Elec. Inc.*, 852 F.2d 79 (3d Cir. 1988).

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with holdup power that can frustrate or completely derail the reorganization efforts of the debtor in possession.⁴⁵⁸

Conversely, when a debtor in possession is the licensor under an intellectual property license and decides to reject the license, section 365(n) of the Bankruptcy Code allows the nondebtor licensee to treat the license as either (i) terminated, or (ii) effective through the end of the remaining term. If the licensee elects to retain the license, it cannot compel any performance by the debtor, but it retains the ability to use certain of its rights under the license for the remaining term, for which it must continue to pay any royalties or other fees required by the terms of the license. Additionally, the nondebtor licensee may assert any damages for nonperformance by the debtor through a setoff against any fees or payments it owes under the license. Notably, the definition of intellectual property does not include foreign intellectual property or trademarks, which often poses an issue under section 365(n). In the context of trademarks, the issue is particularly challenging when the trademarks are integrated into a license with intellectual property (as that term is currently defined under the Bankruptcy Code). The treatment of trademarks under section 365 is addressed separately in the following section.

Intellectual Property Licenses: Recommendations and Findings

Intellectual property licenses can represent valuable assets of the estate and may be necessary to the reorganization of the debtor in possession. Thus, the treatment of these licenses under section 365 of the Bankruptcy Code is often a critically important issue in the case. The Commission reviewed open issues relating to intellectual property licenses in chapter 11.

The Commissioners evaluated the statutory interpretation and practical issues raised by the debate between supporters of the hypothetical approach, on the one hand, and supporters of the actual approach, on the other hand, concerning the ability of a debtor in possession (as licensee) to assume (*i.e.*, keep and use) an intellectual property license without the consent of the nondebtor party (as licensor).⁴⁵⁹ The Commissioners acknowledged that nondebtor licensors may have legitimate concerns about providing their intellectual property to a party other than the debtor, but those concerns should not exist when the debtor in possession proposes to assume and perform in accordance with the license. In those instances, the licensor would be receiving the benefit of its bargain. The Commissioners recognized that application of the hypothetical test results in artificial barriers to the reorganization of the debtor in possession — an outcome that directly undercuts a fundamental policy underlying the Bankruptcy Code. The Commission voted to reject the hypothetical approach and to adopt and codify the actual approach. The Commission further recommended that Congress amend the Bankruptcy Code to expressly authorize the debtor in possession to assume executory intellectual property licenses.

⁴⁵⁸ See, e.g., David R. Kuney, *Intellectual Property in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 Am. Bankr. Inst. L. Rev. 593 (2001).

⁴⁵⁹ See Written Statement of Robert L. Eisenbach III, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3–6 (June 4, 2013) (discussing the tests in practical terms), available at Commission website, *supra* note 55; Written Statement of Lisa Hill Fenning, Partner, Arnold & Porter LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3–6 (June 4, 2013) (discussing impact of bankruptcy law on intellectual property licenses), available at Commission website, *supra* note 55.

The Commissioners also critically analyzed whether the result of the hypothetical test (*i.e.*, no assumption without the consent of the nondebtor licensor) was good policy in the actual assignment context. Admittedly, the ability to exclude others from using your intellectual property is a key element of intellectual property ownership. This right provides intellectual property owners some control over the use of their property and a means to monetize at least some of the value of their property. The assignment by the debtor in possession of an intellectual property license, in accordance with the terms of section 365(f) (requiring, among other things, adequate assurance of future performance and assumption of the entire agreement), arguably does not significantly decrease the value of the licensor's right to exclude users.

The Commissioners debated the advantages and disadvantages of providing debtors in possession with more flexibility to assign intellectual property licenses under the Bankruptcy Code. Some of the Commissioners believed that this flexibility was necessary to maximize the value of the estate and to facilitate certain reorganization transactions. In considering the value of the license from both the licensor's and licensee's perspectives, they observed that U.S. assignment laws are more restrictive than those in many foreign jurisdictions.⁴⁶⁰ Moreover, many of the Commissioners did not believe that the identity of the debtor, absent unusual circumstances, was *per se* a critical factor in the licensing relationship. Rather, factors such as the licensee's ability to pay, to maintain the desired integrity and quality of the intellectual property, and to comply with all obligations imposed by the license are likely more relevant and important.

The Commissioners acknowledged that the identity of the licensee could be critical if the proposed assignee was a competitor of the licensor. In those instances, nondebtor licensors should have the ability to block a proposed assignment by the debtor licensee. The Commission supported a proposal that would permit a debtor in possession to assign an intellectual property license freely under section 365(f)(1) and (2), subject to a nondebtor licensor's right to demonstrate that the hardship imposed on it by the proposed assignment to one of its competitors would significantly outweigh the benefit to the estate.

The Commission also reviewed the exclusion of foreign patents and copyrights from the definition of intellectual property in section 101(35A) of the Bankruptcy Code. Foreign patents and copyrights are excluded from this definition because they are not covered by title 35 or title 17 of the U.S. Code. The Commissioners believed that licenses for foreign patents, copyrights and trademarks (subject to the limitations proposed for U.S. trademarks below), although generally not governed by U.S. law, should receive the same treatment in bankruptcy as U.S. licenses. Moreover, licensees under licenses of foreign intellectual property should receive the same protections as licensees under U.S. licenses pursuant to section 365(n) of the Bankruptcy Code. The Commission found no reasonable basis for treating foreign intellectual property differently.

⁴⁶⁰ See, e.g., M. Reutter, *Intellectual Property Licensing Agreements and Bankruptcy*, in *Research Handbook On Intellectual Property Licensing* 281 (Jacques de Werra ed., 2013).

5. Trademark Licenses

Recommended Principles:

- “Trademarks,” “service marks,” and “trade names,” as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of “intellectual property” under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.
- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of “royalty payments” under section 365(n) should be expanded to include “other payments” contemplated by the trademark, service mark, or trade name license.

Trademark Licenses: Background

As noted above, trademarks are not included in the definition of “intellectual property” under section 101(35A) of the Bankruptcy Code. Congress made the conscious decision in the 1988 amendments to exclude this kind of intangible property because trademarks have slightly different characteristics as compared to other intangible property that is included in the definition of intellectual property. One key difference is that any transfer of a trademark, including a license or assignment, must include a transfer of the associated business operations (referred to as “good will” under applicable nonbankruptcy law).⁴⁶¹ In addition, trademark licenses raise other challenges, as explained by the legislative history of Bankruptcy Code section 365(n):

⁴⁶¹ The relevant portion of the Lanham Act provides:

(1) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. Notwithstanding the preceding sentence, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of an amendment under section 1051(c) of this title to bring the application into conformity with section 1051(a) of this title or the filing of the verified statement of use under section 1051(d) of this title, except for an assignment to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing.

(2) In any assignment authorized by this section, it shall not be necessary to include the good will of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

15 U.S.C. § 1060(a).

[T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor licensors. While such rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others, such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.⁴⁶²

Several commentators have discussed the uncertainty created for nondebtor licensees of a debtor's trademarks given the exclusion of trademarks from the definition of intellectual property and section 365(n). Courts have struggled with the treatment of trademark licenses and the consequences of rejection pursuant to section 365 by a debtor licensor of a license with a nondebtor licensee.⁴⁶³ Some courts have determined that the rejection of such an agreement terminates the nondebtor licensee's rights to use the relevant trademarks and any associated goodwill, and grants the nondebtor party only the right to file a claim for monetary damages against the estate.⁴⁶⁴ Other courts have determined that the debtor in possession's⁴⁶⁵ rejection of a license constitutes only a breach of such agreement, which is consistent with section 365(g), and that the nondebtor licensee may continue to exercise its rights under the rejected agreement consistent with applicable nonbankruptcy law.⁴⁶⁶ In addition, some courts have determined that trademark licenses are not executory contracts and therefore cannot be rejected.⁴⁶⁷

Similar to other intellectual property, a trademark license may be an integral component of a nondebtor's business — particularly in the franchising context. In the event that a licensor files for bankruptcy, a bankruptcy provision that automatically strips the nondebtor licensee of all rights to use the debtor's trademarks and any associated goodwill upon the debtor in possession's rejection of the trademark license could devastate the nondebtor's business. Conversely, the ability of the debtor in possession to reorganize successfully may hinge, at least in part, on its ability to repossess

462 S. Rep. No. 100–505, at 5 (1988), *reprinted in* 1988 U.S.C.A.N. 3204 (citations omitted).

463 *See, e.g., In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009), *aff'd sub nom. Mauro Motors Inc. v. Old Carco LLC*, 420 F. App'x 89 (2d Cir. 2011) (“Trademarks are not ‘intellectual property’ under the Bankruptcy Code . . . [so] rejection of licenses by licensor deprives licensee of right to use trademark. . . .”); *In re HQ Global Holdings, Inc.*, 290 B.R. 507, 513 (Bankr. D. Del. 2003) (“[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees’ right to use the trademark stops on rejection.”); *In re Centura Software Corp.*, 281 B.R. 660, 674–75 (Bankr. N.D. Cal. 2002) (“Because Section 365(n) plainly excludes trademarks, the court holds that [licensee] is not entitled to retain any rights in [licensed trademarks] under the rejected . . . Trademark Agreement.”).

464 *See Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc.*, 756 F.2d 1043, 1048 (4th Cir. 1985) (no right to continue to use mark upon rejection). Such a claim is treated as an unsecured prepetition claim.

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

466 *See Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC*, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012) (holding that *Lubrizol* was wrongly decided and that the transfer of rights embodied in trademark or other IP licenses could not be “vaporized” by rejection). “[R]ejection is not the ‘functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the position they occupied before the contract was formed.’ It ‘merely frees the estate from the obligation to perform’ and ‘has absolutely no effect upon the contract’s continued existence.’” *Id.* (citations omitted).

467 *See also In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010) (trademark license not executory and not subject to rejection under facts of case). Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not — as occurred in this case — use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve. *Id.* at 967–68. *But see In re New York City Shoes, Inc.*, 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (exclusive trademark licensing agreement providing for annual royalties was executory).

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its trademarks and any associated goodwill and then redeploy these assets in a more productive manner consistent with its reorganization efforts.

Trademark Licenses: Recommendations and Findings

The Commission considered whether adding trademarks to the definition of intellectual property under section 101(35A) of the Bankruptcy Code was a workable solution. Several Commissioners noted that the concerns underpinning the decision by Congress in the 1988 amendments to exclude trademarks from the definition of intellectual property still persist. Generally, applicable nonbankruptcy law continues to treat trademarks differently in comparison to other intangible property. These Commissioners did not believe that the process provided in section 365(n) would necessarily work for all trademark licenses or generate the fair result — considering both the interests of the estate and the nondebtor licensee — in every case.

The Commissioners recognized, however, the uncertainty surrounding the treatment of trademark licenses in chapter 11 cases. They discussed how these licenses, to the extent they are deemed executory contracts under the Bankruptcy Code, would be treated under the recommended principles for rejection of executory contracts and leases.⁴⁶⁸ For example, the rejection of the trademark license would constitute a breach by the debtor. It would not terminate the license or eviscerate the nondebtor licensee's rights under the license. The rejection likely would require, however, the nondebtor licensee to turn over the right to use the trademark and any associated goodwill to the estate. Moreover, the nondebtor licensee would not be able to require performance by the debtor in possession or seek equitable or injunctive relief.

The Commission considered whether section 365(n) could be modified to accommodate the unique attributes of trademark licenses and the related concerns of both the debtor licensor and the nondebtor licensee. The Commissioners discussed the advantages and disadvantages of including trademarks within the definition of intellectual property under the Bankruptcy Code. Some Commissioners believed that such inclusion was problematic because of the goodwill associated with the marks and the frequent need of trademark licensees to have access to the related products or goods, or components thereof, to utilize the marks legitimately under the license. Moreover, these Commissioners raised concerns about a debtor licensor's need to monitor quality control of the use of any marks by a licensee. Other Commissioners believed that the statute could incorporate appropriate protections and limitations to protect debtor licensors and mitigate the valid concerns regarding goodwill and ongoing compliance with the license by the licensee. The Commissioners expressed concern about the ongoing ambiguity surrounding trademarks in bankruptcy, and the related costs imposed on a debtor in possession and the estate, as well as the potential harm to the nondebtor licensee's business.

After considering the alternatives and the 2014 Innovation Act proposed in Congress,⁴⁶⁹ the Commission determined that trademark licenses should be included in the definition of intellectual property licenses under the Bankruptcy Code. In reaching this conclusion, the Commission agreed

⁴⁶⁸ See Section V.A.3, *Rejection of Executory Contracts and Unexpired Leases*.

⁴⁶⁹ See Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013), available at <https://www.congress.gov/113/bills/hr3309/BILLS-113hr3309rfs.pdf>.

that section 365(n) should be amended to address certain unique aspects of trademark licenses, including a provision that would allow a debtor in possession to monitor quality control, but otherwise not impose obligations on the debtor in possession if the license is rejected. The Commission also agreed that section 365(n) needs to expressly require a nondebtor licensee electing to retain its rights under the trademark license to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed marks; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed marks.

6. Real Property Leases

Recommended Principles:

- The trustee's time to assume or reject unexpired nonresidential real property leases under section 365(d)(4) of the Bankruptcy Code should be extended from 210 days to one year after the petition date or date of the order for relief, whichever is later, in the interest of enhancing prospects for reorganization.
- The calculation of postpetition rent under a real property lease should be calculated under the accrual method, allowing the trustee to treat rent accrued prior to the petition date as a prepetition claim and rent accrued on and after the petition date as a postpetition obligation. The trustee should be required to pay any such postpetition rent obligation on or before 30 days after the petition date or date of the order for relief, whichever is later. The trustee should pay all subsequent rent obligations accruing postpetition but prior to any rejection of the lease on a timely basis in accordance with the terms of the lease.
- A landlord's claim for unperformed obligations under section 365(d)(3) should apply only to monetary obligations. Such claim for unperformed monetary obligations should not receive superpriority treatment, but should instead constitute an administrative claim under section 503(b)(1) that is payable under section 507(a)(2).
- The meaning of the term "rent" under section 502(b)(6) should not be based on whether an obligation is labeled as "rent" under the lease. Rather, the Bankruptcy Code should define "**rent**" as any recurring monetary obligations of the debtor under the lease.
- The calculation of rejection damages for real property leases under section 502(b)(6) should be clarified as follows:

The claim of a lessor for damages resulting from the termination of a lease of real property shall not exceed:

- (i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation; plus*
- (ii) Any unpaid rent due under the lease on the termination date.*

For purposes of this section:

*The “**alternative rent calculation**” is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date.*

*The “**termination date**” is the earlier of the petition date and the date on which the lessor repossessed, or the lessee surrendered, the leased property.*

In calculating the rent due or reserved under the lease, such calculation should be done without acceleration.

- A landlord should be required to make reasonable efforts to mitigate damages in the event that the trustee rejects the lease under section 365, regardless of whether mitigation is required by applicable nonbankruptcy law. Any mitigation or cover received by, or security deposit held by, the landlord should reduce the landlord’s prepetition claim for purposes of calculating the section 502(b)(6) claim. A landlord’s obligation to mitigate damages should continue through the claims objection deadline or the date of the order allowing the claim, whichever is earlier.
- A landlord’s claims for the debtor’s acts and omissions resulting in damage to the real property, other than those claims relating to the rejection of the lease or for rent under the lease, should not be subject to section 502(b)(6). The landlord should be permitted to assert any such claim as a prepetition claim against the estate, subject to the trustee’s or a party in interest’s right to object and the general claims allowance process.

Real Property Leases: Background

Many chapter 11 debtors have one or more unexpired leases of nonresidential real property as of the petition date. These leases may be for the debtor’s headquarters, stores, warehouses, or factories. They may be necessary to the debtor in possession’s⁴⁷⁰ reorganization efforts or otherwise represent valuable assets that the debtor in possession can use to maximize the value of the estate. Alternatively, they may be above-market leases or used in a part of the business being closed or downsized through the reorganization. In either scenario, a debtor in possession’s ability to assume, assign, or reject unexpired leases of nonresidential real property is important to the resolution of its case.

The Bankruptcy Code includes several provisions that specifically address the rights and obligations of the debtor in possession and the nondebtor landlord under unexpired leases of nonresidential real property leases. For example, section 365(d)(3) requires the debtor in possession to timely perform obligations “arising from and after the order for relief under any unexpired lease of nonresidential real

⁴⁷⁰ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

property, until such lease is assumed or rejected.”⁴⁷¹ In addition, section 365(d)(4) requires the debtor in possession to assume or reject any nonresidential real property lease within 120 days after the petition date, with one 90-day extension of that deadline for cause.⁴⁷² The debtor in possession generally is given until plan confirmation to assume or reject executory contracts and other kinds of leases.⁴⁷³

Commentators and practitioners have raised issues concerning several of these provisions. Many commentators have criticized the shortened deadline for the debtor in possession to assume, assign, or reject a nonresidential real property lease under section 365(d)(4) of the Bankruptcy Code.⁴⁷⁴ Prior to the BAPCPA Amendments, a debtor in possession had an initial 60 days to review its unexpired nonresidential leases, but it could obtain one or more extensions of this deadline for cause and with court approval.⁴⁷⁵ Some commentators and landlords believed that courts were granting debtors in possession very lengthy extensions of the section 365(d)(4) deadline on a routine basis.⁴⁷⁶ They believed that these open-ended extensions significantly impaired the landlords’ rights under the leases and nonbankruptcy law, as well as their ability to identify substitute lessees and negotiate substitute leases in a timely manner.⁴⁷⁷

As a result of the BAPCPA Amendments, section 365 provides a debtor in possession with 210 days following the petition date to decide whether it will assume or reject each of its nonresidential real property leases, unless the applicable landlord consents to an extension of this deadline. Some commentators suggested, immediately following the BAPCPA Amendments, that this single change to the Bankruptcy Code would discourage large retail chains from filing chapter 11 petitions.⁴⁷⁸ Large retail chains, in particular, frequently have hundreds of unexpired nonresidential real property leases as of the petition date, and the prospect of reviewing and making prudent assumption or rejection decisions for each location within 210 days of the petition date, according to these commentators, would likely be too daunting and thus discourage filings in the first place.⁴⁷⁹ Empirical and anecdotal evidence since 2005 suggests that this change in a debtor in possession’s time to assume or assign nonresidential real property leases is at least a contributing factor to both the decline in retail filings and the results that were achieved in certain retail debtor cases since 2005.⁴⁸⁰

471 11 U.S.C. § 365(d)(3).

472 *Id.* § 365(d)(4).

473 *Id.* § 365(d)(2).

474 *Id.* § 365(d)(4).

475 *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?*, Hearing before the H. Subcomm. on Commercial and Administrative Law, 111th Cong. 96 (2009) (statement of Professor Jack F. Williams, Robert M. Zinman ABI Resident Scholar (2008–09)) [hereinafter Williams Statement].

476 See, e.g., *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) (discussion prior law), available at Commission website, *supra* note 55. See generally *Transcript, NYIC Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, available at Commission website, *supra* note 55.

477 “The deadline was originally enacted to address problems caused by extended vacancies or partial operation by a debtor of tenant space located in shopping centers which reduced customer traffic to other nondebtor tenants due to delays in debtors deciding whether to assume or reject real property leases.” *In re FPSDA I, LLC*, 450 B.R. 392, 399 (Bankr. E.D.N.Y. 2011).

478 See, e.g., Williams Statement, *supra* note 475, at 97 (“Professor Ken Klee suggests one other possible outcome — retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases.”) (citations omitted).

479 See, e.g., *id.* at 96–97; *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that 210 days may not be sufficient for a debtor to make an informed decision), available at Commission website, *supra* note 55; *Written Statement of Commercial Finance Association: CFA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 8 (Nov. 15, 2012) (stating that the 210-day period to assume or reject a nonresidential lease is too short, discourages reorganization, and impairs secured creditor recoveries), available at Commission website, *supra* note 55.

480 See Kenneth Ayotte, *An Empirical Investigation of Leases and Executory Contracts*, (paper presented at 2014 symposium) (draft on file with Commission) (finding that BAPCPA is “associated with a significantly lower probability of reorganization for the most lease-intensive firms”). See also *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 5 (Nov. 3, 2012) (arguing that the 210-day period is insufficient, particularly for retail debtors), available

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Courts also take different approaches to calculating the timely payments a debtor in possession is obligated to make under its nonresidential real property leases pursuant to section 365(d)(3). Some courts determine the prepetition or postpetition status of rent amounts owed by a debtor in possession using a billing approach based on the landlord's invoice date.⁴⁸¹ Other courts take an accrual approach and allocate the outstanding amounts between the prepetition and postpetition periods accordingly.⁴⁸² Courts also differ on the priority accorded to any unpaid postpetition amounts due under section 365(d)(3).⁴⁸³

Similarly, if a debtor in possession rejects a nonresidential real property lease, the landlord's claim for rejection damages is generally subject to the cap provided by section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) generally "limits a landlord's 'damages resulting from the termination of a lease of real property' to an amount equal to the rent the debtor-tenant would have paid for a period of one to three years, depending on the remaining term of the lease."⁴⁸⁴ The calculation of the section 502(b)(6) cap, as well as what constitutes rent or otherwise should be included in the calculation, often produces litigation and uncertain results in chapter 11 cases.⁴⁸⁵ Notably, courts are split regarding the application of the section 502(b)(6) cap to nontermination damages relating to the lease, which could constitute millions of dollars and significantly impact unsecured creditors' *pro rata* share of estate assets.⁴⁸⁶

at Commission website, *supra* note 55; *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (testifying that the primary problem in retail reorganizations is lender control and stating that "[l]enders are sometimes willing to provide only enough financing to position a debtor for liquidation in the first few months of the case, and then impose restrictive covenants in post-petition financing agreements that either direct an immediate liquidation of the company, or include covenants or borrowing reserve rights that effectively allow the lender to 'pull the plug' on the retailer only a few months into the case"), available at Commission website, *supra* note 55; *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (explaining the tension in the timing regarding the desire of the secured creditor to liquidate the debtors' assets and the ability of the debtor to effectively conduct going-out-of-business ("GOB") sales at its retail locations; given the 210-day limit set by BAPCPA and given the fact that a GOB sale takes at least 120 days in most cases, the debtor has 30 to 90 days to sell its company; landlords are also unwilling to negotiate, which increases the prevalence of quick liquidations in retail cases), available at Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (stating that the 210-day limit to assume or reject nonresidential leases puts retailers in a timing pinch; because GOB sales generally take at least 120 days and must take place in their retail locations, the 210-day limit to assume or reject leases puts inordinate pressure on debtors to decide within 90 to 120 days after filing to either quickly file a chapter 11 plans while complying with all their lenders' requirements, or to liquidate; also stating that the 210-day deadline to assume or reject nonresidential leases means it is nearly impossible for a middle-market retail company to do anything but conduct a GOB sale), available at Commission website, *supra* note 55.

481 See *Centerpoint Props. v. Montgomery Ward Holding Corp.* (In re *Montgomery Ward Holding Corp.*), 268 F.3d 205, 209–10 (3d. Cir. 2001); *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–8 (June 4, 2013) (describing how this "stub rent" problem means that landlords are, perhaps unfairly, losing money because of the timing of debtors' bankruptcy filings), available at Commission website, *supra* note 55.

482 See *In re Stone Barn Manhattan LLC*, 398 B.R. 359, 362–65 (Bankr. S.D.N.Y. 2008) (using the accrual method but providing historical overview and case cites of the accrual versus billing date approach).

483 Compare *In re Oreck Corp.*, 506 B.R. 500 (Bankr. M.D. Tenn. 2014) (holding that debtor's obligation to pay occurred prepetition was not subject to priority treatment) with *In re Leather Factory Inc.*, 475 B.R. 710 (Bankr. C.D. Cal. 2012) (holding that "stub rent" owed to landlord was a priority administrative claim).

484 11 U.S.C. § 502(b)(6); Michael St. Patrick Baxter, *The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?*, 83 Am. Bankr. L. J. 111 (2009).

485 See, e.g., *In re Heller Ehrman LLP*, 2011 WL 635224 (N.D. Cal. Feb. 11, 2011) (discussing challenges in determining remaining term of lease); *In re Titus & McConomy, LLP*, 375 B.R. 165 (Bankr. W.D. Pa. 2007) (holding that, because one year's rent was greater than 15 percent of remaining term of lease following petition date, section 502(b)(6)(A) determined amount of cap was equal one year's rent).

486 Baxter, *supra* note 484, at 113–14.

Real Property Leases: Recommendations and Findings

The Commission reviewed several issues relating to nonresidential real property leases. Several Commissioners voiced strong concerns regarding the shortened deadline for a debtor in possession to assume or reject nonresidential real property leases under section 365(d)(4). The Commissioners suggested that the current deadline is preventing potential debtors from using chapter 11, at least on a voluntary and timely basis, and is making it more difficult for retail chains to reorganize their businesses.⁴⁸⁷ The Commissioners also noted that the 210-day deadline is misleading because postpetition lenders have been requiring debtors in possession to make their decisions about nonresidential real property leases as early as 120 to 150 days after the petition date to permit these lenders to preserve their security interests in the debtors' leaseholds before the expiration of the section 365(d)(4) deadline.⁴⁸⁸

Other Commissioners, while acknowledging these troubling facts, emphasized the need to balance the concerns raised by landlords before the BAPCPA Amendments when courts were granting very lengthy extensions.⁴⁸⁹ They encouraged the Commission to find a compromise that would provide more flexibility to debtors in possession to secure financing and to review their unexpired leases within a reasonable time frame without eliminating the certainty that section 365(d)(3) currently

⁴⁸⁷ See, e.g., Sharon Bonelli, Isabel Hu, Gregory Fodell, *U.S. Retail Case Studies in Bankruptcy Enterprise Value and Creditor Recoveries*, Fitch Ratings, Apr. 16, 2013; *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) ("The deadline established under BAPCPA for a debtor to assume or reject unexpired leases of nonresidential property has had a substantial and unfortunate affect on retailers' ability to meet liquidity needs and obtain extended postpetition financing — the lynchpin to any successful retail reorganization."), available at Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (noting that the maximum time limit to assume or reject nonresidential real property leases should be amended, as it takes time to thoroughly assess whether a lease should be maintained for the value of reorganization efforts), available at Commission website, *supra* note 55; *Oral Testimony of Grant Stein: AIRA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 7, 2013) (AIRA Transcript) (noting that the court should allow more time for the assumption or rejection if it is appropriate in the circumstances), available at Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 8–9 (Nov. 15, 2012) ("Debtors and their secured and unsecured creditors must make decisions about whether to retain leases in a period of time that is often unrealistically short. As a result, businesses that might have been reorganized or sold as going concerns to new owners are liquidated instead. Because they know that debtors with significant leases will have difficulty reorganizing, lenders are less willing to support reorganizations with DIP financing. They do not want to begin lending money to a chapter 11 debtor only to have to choose, 7 months later, between agreeing to an unfavorable deal with a landlord that has such significant leverage and liquidating the debtor, possibly at a loss to the lender. So they simply refuse to provide DIP financing in the first place, forcing debtors to liquidate before they have had an opportunity to make operational changes, regardless of the potential for reorganization. In addition, going concern asset sales (a frequent form of 'reorganization' without a plan) become more difficult and less advantageous to creditors and owners because buyers have insufficient time to assess the value of an enterprise with important leases. Uncertainty about value always results in lower prices and therefore lower payments to creditors. Worse, such uncertainty can render going concern sales so difficult that they are not even pursued, again resulting in otherwise avoidable liquidations."), available at Commission website, *supra* note 55.

⁴⁸⁸ See *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (stating that the deadline should be expanded to allow time for a debtor to secure postpetition financing and conduct a going-out-of-business sale and stating that prepetition lenders often demand provisions that result in a liquidation sale before the expiration of the 210-day period), available at Commission website, *supra* note 55. But see *Written Statement of David L. Pollack, Partner, Ballard Spahr LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (June 4, 2013) (stating that neither section 365(d)(4) time limits nor commercial landlords are causing retailers to fail and providing specific case examples to support assertion; also noting that retailers are failing because of other reasons, such as DIP financing conditions and reluctance of trade creditors to continue to extend credit), available at Commission website, *supra* note 55. See also Ayotte, *An Empirical Investigation of Leases and Executory Contracts*, *supra* note 480 (finding that the seven-month limit to assume or reject a commercial lease instituted by BAPCPA (absent an extension from the landlord) "accelerated real estate lease disposition decisions"). See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

⁴⁸⁹ See, e.g., *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) ("The 2005 amendments that created more certainty for shopping center owners now provide an important 'firewall' which prevents the failure of one retailer from cascading to other businesses. Under the prior law, lingering uncertainty caused neighboring stores to suffer from reduced traffic and sales while potential new tenants were reluctant to rent space in a shopping center with an uncertain future. For property owners, the contraction in credit has been even more problematic; a bankrupt tenant can cause a shopping center to default on a mortgage with no ability to cure the default. Such defaults include covenants to maintain minimum occupancy and debt service coverage."), available at Commission website, *supra* note 55.

provides to landlords.⁴⁹⁰ After considering and debating different approaches that ranged from reversion to the pre-BAPCPA standard to maintenance of the *status quo*, the Commission voted to provide the debtor in possession one year from the petition date to make its assumption, assignment, or rejection decision with respect to nonresidential real property leases.

The Commission also discussed the split in the courts regarding the method — *i.e.*, the billing approach or the accrual approach — that should be used to determine whether certain rent owed under the lease should be deemed a prepetition or a postpetition obligation. The Commission reviewed case law citing both approaches to determine which approach should be adopted and codified, and focused its efforts on creating, first and foremost, a uniform standard. Ultimately, the Commission decided that the accrual method, which allocates rent between the prepetition and postpetition periods based on the date of filing, was a fair method and most closely aligned with the purpose of section 365(d)(3).

The Commission further considered the scope of a debtor in possession's obligations under section 365(d)(3). Some of the Commissioners commented on the ambiguity in the case law regarding which obligations were captured by section 365(d)(3) and how those obligations, if deferred or unpaid, should be treated. With respect to which obligations should be deemed “rent,” the Commission reviewed the language of section 365(d)(3), which references section 365(b)(2), but not historical nonmonetary obligations in section 365(b)(1). The Commissioners debated whether this omission in the statute suggests that a debtor in possession should be required to perform all nonmonetary obligations on and after the petition date as provided in section 365(d)(3). Several Commissioners, however, highlighted that such a reading of section 365(d)(3) may be inconsistent with the Commission's recommended policies and approaches. Specifically, these Commissioners asserted that a debtor in possession (i) should not be required to perform under any executory contracts or unexpired leases, except to pay for postpetition goods and services (including rent), pending assumption or rejection; and (ii) should not be required to cure nonmonetary defaults that occurred prior to assumption. In light of these recommendations and the Commission's proposal for a relatively modest extension of the section 365(d)(4) deadline, the Commission decided to recommend limiting section 365(d)(3) to monetary obligations under the leases and to provide ordinary administrative priority (not superpriority) to any such unpaid or deferred obligations under section 365(d)(3).

In addition, the Commissioners evaluated the inconsistent application of section 502(b)(6) to calculate the maximum amount of a landlord's rejection damages. The Commission agreed with courts that have held that whether a given obligation is labeled as “rent” under a lease should not determine whether such obligation is subject to the section 502(b)(6) cap. The Commissioners identified obligations that have been commonly considered as “rent” (*e.g.*, monthly payments for occupying the property (including base rent, additional rent, percentage rent), common area

⁴⁹⁰ *Id.* at 2 (June 4, 2013) (stating that the time limits for debtors to assume or reject a nonresidential lease introduced by BAPCPA have “provid[ed] shopping center owners with reasonable certainty as to the disposition of leases, have prevented deterioration in shopping center properties and helped owners have access to credit to finance construction and renovation”), available at Commission website, *supra* note 55; *Oral Testimony of the Honorable Melanie Cyganowski (Ret.)*, former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 19 (Nov. 15, 2012) (CFA Transcript) (stating that it would be beneficial to the court and will encourage more secured lenders to support middle-market borrowers if the BAPCPA Amendments relating to lease and plan deadlines were repealed, or at a minimum amended to provide judicial discretion to be exercised to modify the deadlines as appropriate), available at Commission website, *supra* note 55.

maintenance charges, taxes, and insurance) and determined that the definition of “rent” suggested by the advisory committee — “any recurring monetary obligations of the debtor under the lease” — adequately captured these obligations. The Commissioners also analyzed the varying interpretations and applications of the formula for calculating the cap on rejection damages under section 502(b)(6). The Commission agreed that many courts have confused or misapplied the formula and that, simply stated, the cap should be the rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents. Accordingly, the Commission voted to recommend clarifying the calculation formula.

Finally, the Commission considered the treatment of nontermination damages that a landlord may assert against the estate. These claims typically arise out of the debtor’s use or occupancy of the property and are not related to the debtor’s rejection of the lease. Notably, section 502(b)(6) applies to, and limits, “the claim of a lessor for damages resulting from the termination of a lease of real property.” Accordingly, the Commission agreed that a landlord should be able to file a prepetition claim against the estate, to the extent that the landlord can establish a legal basis and adequate factual support for such claim, for damages not resulting from the rejection of the lease. Such claim would be subject to the claims objection and allowance process under the Bankruptcy Code.

B. Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession’s use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.⁴⁹¹ If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.⁴⁹² Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.⁴⁹³

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor’s assets (*i.e.*, a section 363x sale), the court should approve the use, sale, or lease of a debtor’s assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is

⁴⁹¹ 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute “cash collateral,” then the debtor must obtain the secured creditor’s consent or court approval. *Id.* § 363(c)(2).

⁴⁹² *Id.* § 363(b).

⁴⁹³ *Id.* § 363(f).

referred to as an “enhanced” or “intermediate” level of review that considers not only the process adopted by the board of directors (or similar governing body) to approve the transaction but also the reasonableness of the decision itself.

- Only the trustee should be able to propose the use, sale, or lease of a debtor’s assets outside the ordinary course of business. Accordingly, no change to existing law is suggested on this point.
- A secured creditor’s collateral should not be subject to a mandatory surcharge in favor of the estate but the court should retain the authority to make appropriate allocations of value to the estate as may be warranted under the circumstances pursuant to sections 506(c) and 552(b) of the Bankruptcy Code, as clarified by the related principles. See Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.
- For the standard of review governing section 363x sales, see Section VI.B, *Approval of Section 363x Sales*.

General Provisions for Non-Ordinary Course Transactions: Background

In general, section 363(b) of the Bankruptcy Code provides that the debtor in possession,⁴⁹⁴ “after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate.”⁴⁹⁵ The debtor in possession can use, sell, or lease a single asset, multiple assets, a division, or more. A sale of all or substantially all of the debtor’s assets is addressed separately in these principles and is subject to a different standard of review and additional procedures.⁴⁹⁶

Under section 363(b), a debtor in possession generally must provide at least 21 days’ notice of a motion to approve a proposed use, sale, or lease of property.⁴⁹⁷ In general, any party in interest may object to the motion. At the hearing, the debtor in possession bears the burden of proof on the motion and generally must satisfy that burden by a preponderance of the evidence.⁴⁹⁸ Courts generally evaluate section 363(b) motions under a business judgment standard. More precisely, courts often state they will approve the motion only if it represents an exercise of the debtor in possession’s sound business judgment.⁴⁹⁹ But, courts are not always clear or consistent in explaining the factors they consider under this business judgment standard.

⁴⁹⁴ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁴⁹⁵ *Id.* § 363(b).

⁴⁹⁶ See Section VI.B, *Approval of Section 363x Sales*.

⁴⁹⁷ Fed. R. Bankr. P. 2002.

⁴⁹⁸ *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) (“[A] debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business will aid the debtor’s reorganization”); *In re Telesphere Commc’ns, Inc.*, 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) (“[T]he proponent of the sale bears the ultimate burden of persuasion”); *In re Ionosphere Clubs, Inc.*, 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) (“[Debtor] clearly bears the burden of demonstrating that a sale of property out of the ordinary course of business under § 363(b) of the [Bankruptcy] Code will aid [debtor’s] reorganization and is supported by a good business justification.”).

⁴⁹⁹ *In re On-Site Sourcing, Inc.*, 412 B.R. 817, 822 (Bankr. E.D. Va. 2009) (“A § 363(b) sale is generally viewed as quicker. Only a motion and a hearing are required, and most courts apply a ‘business judgment test’ to determine whether to approve the sale.”) (quoting *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009)).

General Provisions for Non-Ordinary Course Transactions: Recommendations and Findings

The Commissioners engaged in a detailed review of the various kinds of non-ordinary course transactions pursued by debtors in possession under section 363(b). Debtors in possession have used this provision to enter into long-term equipment lease arrangements or new real property leases that require a substantial outlay of resources; to hire a service provider who is not a professional under section 327; and even to compromise and settle a cause of action.⁵⁰⁰ The most common use of section 363(b), however, is to sell the debtor's assets. In each of these instances, the estate is potentially losing something — *i.e.*, cash in the lease, hiring, and settlement scenarios, and assets in the sale context. The Commissioners thus emphasized the important roles of process and review in the approval of these transactions.

The Commissioners examined the various standards of review applicable to similar transactions under state law. In many cases, directors' decisions are protected under state law by the business judgment rule, which presumes that “in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.”⁵⁰¹ Courts have articulated slightly different standards for reviewing proposed transactions under either the business judgment rule or some enhanced form of scrutiny. These variations typically depend on the kind of transaction at issue and the parties involved in the transaction.

For example, some courts undertake a very deferential review of a company's business judgment, focusing largely on the process followed by the board of directors to evaluate and approve the proposed transaction; these courts then defer to the company's articulated business justifications.⁵⁰² This type of deferential judicial review often is explained by the notion that business decisions are better made in the boardroom than the courtroom.⁵⁰³ Other courts scrutinize proposed transactions more closely, reviewing not only the process implemented by the company, but also the reasonableness of the board of directors' business judgment under the circumstances of the case.⁵⁰⁴ This latter review often is referred to as an “enhanced” or “intermediate” business judgment standard. In certain

500 *In re Schipper*, 933 F.2d 513, 515 (7th Cir. 1991) (holding that debtor had “sound business reasons for making the sale”); *In re Con'l Air Lines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986) (“[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business.”); *In re Ionosphere Clubs, Inc.*, 100 B.R. 670, 680 (Bankr. S.D.N.Y. 1989) (finding that debtor “articulated sound business reasons for, and is appropriately exercising business judgment with respect to, its decision to sell [certain assets]”); *In re Baldwin United Corp.*, 43 B.R. 888, 897 (Bankr. S.D. Ohio 1984) (finding that debtors “met their burden of demonstrating that the disposition will aid their reorganization, and is supported by sound business reasons”).

501 *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 52 (Del. 2006) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

502 *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 n.17 (Del. 1994); *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 74 (Del. 2006) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).

503 *See, e.g., Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000) (holding that the Court of Chancery correctly deferred to the business decision of the board because “[t]o rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence”). *See also King v. Terwilliger*, 2013 WL 708495, at *7 (S.D. Tex. Feb. 26, 2013) (finding that compensation issues are business questions “far better suited to the boardroom than the courtroom”); *In re Curlew Valley Assocs.*, 14 B.R. 506, 511 (Bankr. D. Utah 1981) (“[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant. While a court may pass upon the legal effect of a business decision, (for example, whether it violates the antitrust laws), this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance. In short, the decision calls for business not legal judgment.”).

504 *In re Netsmart Techs., Inc. Stockholders Litig.*, 924 A.2d 171, 192 (Del. Ch. 2007). *See also Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994) (“[C]ourt applying [the *Revlon* standard] should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.”).

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limited circumstances, courts apply heightened scrutiny under which the court exercises its own business judgment and determines if the decision is in the best interests of the company.⁵⁰⁵ Finally, if the proposed transaction involves potential self-dealing, conflicts of interests, or insiders, the court may require the company to establish the entire fairness of the transaction.⁵⁰⁶

After much deliberation, the Commission determined that an enhanced business judgment standard was appropriate for evaluating general asset sales and other transactions under section 363(b). The court should approve the sale if it represents a reasonable process and a reasonable exercise of the debtor in possession's business judgment. Moreover, the Commission agreed that only the debtor in possession should be permitted to request the use, sale, or lease of property of the estate, which currently is the structure of section 363.

The Commissioners discussed situations in which the debtor in possession sells assets, and unsecured creditors seek recoveries from that sale, despite the fact that such assets are fully encumbered by a secured creditor's lien. The Commissioners recognized that this situation has occurred more frequently in the most recent economic cycle. Debtors have filed chapter 11 cases with substantially all of their assets fully encumbered by prepetition liens, leaving little value for the debtors' other creditors, at least at the outset of the case. The Commissioners noted that, in some cases, secured lenders will agree to set aside certain amounts for administrative or unsecured claims. The Commissioners, however, did not believe that such surcharges should be mandatory in every section 363 transaction. Rather, parties should remain free to negotiate these types of set-asides based on the facts of any given case. In addition, the Commission reviewed the recommended principles relating to sections 506(c)⁵⁰⁷ and 552(b),⁵⁰⁸ and found that those sections, together with the new procedures proposed for section 363x sales,⁵⁰⁹ sufficiently addressed the underlying concerns.

505 See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981) (indicating that judicial business judgment may be warranted in derivative litigation involving a special litigation committee in which demand was excused under applicable state law). See also, e.g., *In re Telephere Commc'ns, Inc.*, 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("Where an objection is made, the standard to be applied by the court in approving a disposition of assets is variously stated, but the general thrust is that the proposed sale should be in the best interests of the estate."); *In re Am. Dev. Corp.*, 95 B.R. 735, 739 (Bankr. C.D. Cal. 1989) ("The proposed transaction is certainly not in the ordinary course of business and requires [the court's] approval. Debtor has the burden of proof to persuade [the court] that the proposed transaction is appropriate in light of its reorganization effort and should be approved."). Also, some courts have been less deferential with respect to break-up fees. See, e.g., *In re Tiara Motorcoach Corp.*, 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("This court agrees with the position taken in *S.N.A., America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is outside the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, 'the proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.'") (citations omitted); *In re Am. W. Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]he Court must take into consideration what is in the best interests of the estate. As stated, the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'") (citing *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983)). But see Official Comm. of Subordinated Bondholders v. Integrated Res. (*In re Integrated Res., Inc.*), 147 B.R. 650 (S.D.N.Y. 1992), appeal dismissed by 3 F.3d 49 (2d Cir. 1993) (finding that the business judgment rule applied in nonbankruptcy contexts and thus relied upon that standard in the bankruptcy context as well to determine whether the proposed breakup fee at issue was appropriate).

506 *Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002). See also *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

507 See Section VI.C.3, *Section 506(c) and Charges Against Collateral*.

508 See Section VI.C.4, *Section 552(b) and Equities in the Case*.

509 See Section VI.B, *Approval of Section 363x Sales*.

2. Finality of Orders

Recommended Principles:

- The court should not be permitted to reconsider a non-ordinary course transaction after the entry of an order approving the transaction or to reopen an auction unless the court finds extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process) to the auction process that may have had a material effect on the sale results. For purposes of this principle, the potential that a new or continued auction would generate a higher value for the transaction alone does not constitute extraordinary circumstances.

Finality of Orders: Background

In the section 363 sale context, a debtor in possession⁵¹⁰ seeks to obtain the highest and best price for the assets. As explained above, a debtor in possession typically conducts an auction process to facilitate this result.⁵¹¹ The auction procedures are reviewed and approved by the court and may include a marketing and diligence period and rules governing the auction itself.⁵¹² The auction procedures also may contemplate certain bid protections for any stalking horse bidder.⁵¹³ After the auction, the debtor in possession presents the winning bid at the auction to the court for approval under the motion to approve the sale. After the court enters the sale order, parties generally have 14 days to appeal the order or it becomes final.⁵¹⁴ Generally, courts are not permitted to reopen an auction or sale.⁵¹⁵

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

511 See Section IV.C.2, *Timing of Section 363x Sales*.

512 One court concluded that “it was necessary to have in place bidding procedures that would provide a reasonable opportunity for the APA to be tested against the market.” *In re Tex. Rangers Baseball Partners*, 431 B.R. 706, 711 (Bankr. N.D. Tex. 2010). See also *In re Innkeepers USA Trust*, 448 B.R. 131, 148 (Bankr. S.D.N.Y. 2011) (explaining that bid procedures provide “the market and the Debtors the certainty and the ‘rules’ that they need to complete the auction process and move on to plan confirmation”).

513 A leading bankruptcy treatise explains the rationale for deciding such bid protections in advance of the auction:

Frequently, the issue of whether the court should approve buyer protections arises upon a motion to approve bidding procedures. The court is asked to approve, before the fact, procedures the propriety of which may be better determined after the “auction” of the property. For example, the reasonableness of a breakup or topping fee may be more difficult to evaluate in a vacuum before the sale. Whether a particular procedure chilled bidding may not be determinable until after the trustee offers the successful bid to the court for approval. However, the fees are to compensate the bidders for facilitating the auction, for example, by guaranteeing a floor on the bidding. If the court were not to approve the fee until after the auction, the leading bidder would not have the assurance necessary to commit to support the auction. Therefore, authorizing the fee only after the auction would defeat its purpose, and the court should address the issues upon a motion to approve the bid procedures.”

3 *Collier on Bankruptcy* ¶ 363.02[7].

514 Bankruptcy Rule 6004(h) provides that “[a]n order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise.” Fed. R. Bankr. P. 6004(h).

515 See *Contrarian Funds, LLC v. Westpoint Stevens, Inc.* (*In re Westpoint Stevens, Inc.*), 333 B.R. 30 (S.D.N.Y. 2005), *aff’d in part and rev’d in part sub nom.* *Contrarian Funds v. Aretex LLC (In re Westpoint Stevens, Inc.)*, 600 F.3d 231 (2d Cir. 2010). See also *In re Gil-Bern Indus., Inc.*, 526 F.2d 627, 628, 629 (1st Cir. 1975) (“[I]t is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a fairly conducted sale merely because a slightly higher offer has been received after the bidding has closed.”); *In re Bigler, LP*, 443 B.R. 101, 112 (Bankr. S.D. Tex. 2010) (“To reopen the bidding process to allow [a losing bidder] to make its late bid would be an abuse of this Court’s discretion. Accordingly, this Court will not reopen bidding.”).

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Several issues can arise during the course of the sale process, including modifications to the auction procedures without notice to or approval by the court, bidders wanting to submit noncompliant bids, and even late bidders who cause the debtor in possession, the unsecured creditors' committee, or other party in interest to question whether the bid selected at the auction really is the best and highest offer for the debtor's assets. In this context, courts have granted motions to reopen an auction if it would likely result in a better offer.⁵¹⁶ Accordingly, courts face challenging issues and competing interests when confronted with requests to reopen the auction process or to reconsider the order approving the sale under section 363 of the Bankruptcy Code.

Finality of Orders: Recommendations and Findings

The closing of an auction and the entry of a sale order are key steps in the sale of the debtor's assets. They allow the debtor in possession to close the sale and move forward in the case and the successful bidder to take possession of the assets. The Commissioners discussed the importance of the value generated by section 363 sales to the estate, and the common desire to want to ensure that the sale process is extracting as much value as possible from the assets. The Commission reviewed examples in which this desire caused the debtor in possession, the unsecured creditors' committee, or a party in interest to second-guess the auction results or the sale order and to seek related relief from the court.

For example, in the *WestPoint Stevens*⁵¹⁷ chapter 11 case, the debtor in possession obtained approval of the court to conduct an auction for substantially all of the debtor's assets.⁵¹⁸ One of the debtor's secured creditors, Aretex LLC, along with its affiliates, emerged as the winning bidder at the auction.⁵¹⁹ The court approved the sale and entered a sale order permitting the consummation of the sale to Aretex for the highest and best bid.⁵²⁰ But, before the sale closed, certain other lenders moved for a stay of the sale order pending appeal of certain provisions in the sale order related to lien releases, claim satisfaction, and distributions.⁵²¹ On appeal, however, the Second Circuit rejected the appeal as statutorily moot under section 363(m).⁵²²

The Commission also reviewed a contrary example found in the *Foamex* chapter 11 case. In that case, the debtors had selected an all-cash bid that was \$5 million lower than the all-cash bid of the stalking horse because the stalking horse had conditioned its bid on the inclusion of a credit bid if the auction continued past the then-present round. The bankruptcy reopened the auction and directed the debtors in possession to accept the stalking horse bid (which included the credit bid), even though the debtors in possession had complied with the court-approved bid procedures in

516 *In re Foamex Int'l, Inc.*, No. 09-10560 (KJC) (Bankr. D. Del. May 27, 2009). See also *Lithograph Legends, LLC v. U.S. Trustee*, 2009 WL 1209469, at *3 (D. Minn. Apr. 30, 2009) ("A bankruptcy court may disapprove a proposed sale recommended by a debtor-in-possession 'if it has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable.'") (quoting *G-K Dev. Co v. Broadmoor Place Invs., L.P.* (*In re Broadmoor Place Invs., L.P.*), 994 F.2d 744, 746 (10th Cir. 1993)).

517 *Contrarian Funds, LLC v. Westpoint Stevens, Inc.* (*In re Westpoint Stevens, Inc.*), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* *Contrarian Funds v. Aretex LLC* (*In re WestPoint Stevens, Inc.*), 600 F.3d 231 (2d Cir. 2010).

518 *Id.* at 35.

519 *Id.* at 36.

520 *Contrarian Funds LLC v. Aretex LLC* (*In re WestPoint Stevens, Inc.*), 600 F.3d 231, 242 (2d Cir. 2010) (noting that bankruptcy court entered order confirming that "the winning bid presented 'the highest and best bid at the Auction'" (citations omitted)).

521 *Contrarian Funds, LLC v. Westpoint Stevens, Inc.* (*In re Westpoint Stevens, Inc.*), 333 B.R. 30, 37 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* *Contrarian Funds v. Aretex LLC* (*In re WestPoint Stevens, Inc.*), 600 F.3d 231 (2d Cir. 2010).

522 *Contrarian Funds v. Aretex LLC* (*In re WestPoint Stevens, Inc.*), 600 F.3d 231, 247 (2d Cir. 2010).

accepting the previous bid. The court thereafter overruled the objection by the previous winning bidder to the sale.

The Commissioners acknowledged that, in some cases, reopening the auction or reconsidering the sale order may generate additional value for the estate. They also raised concerns, however, that endorsing this type of relief may prevent robust auctions in the first instance because prospective bidders need to understand the rules of the auction and to know that, if they participate according to the rules and win, they will be able to close the sale. This type of certainty and respect for the auction rules and sale order can enhance the auction itself and prevent gamesmanship by prospective bidders.

The Commissioners also noted that courts currently have the ability to reconsider their orders under Rule 60(b) of the Federal Rules of Civil Procedure, which provides that the court may relieve a party from a final order if presented with “newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial” and due to “fraud . . . misrepresentation, or other misconduct of an adverse party.” The Commissioners reviewed cases in which courts have reconsidered (or refused to reconsider) sale orders.⁵²³ They acknowledged that a motion to reconsider a section 363 sale order can be clouded by the prospect of more value for the estate. Nevertheless, the Commissioners believed that more value alone as ground for reopening an auction or setting aside a sale order was too low of a barrier, did not comply with Rule 60(b), and would introduce too much uncertainty into the sale process.

Consequently, the Commission voted to recommend codifying the standards governing requests to reopen an auction or to reconsider and set aside a sale order. Specifically, it determined that such relief should be warranted only in instances when the evidence presented at the hearing demonstrates procedural impediments in the auction or sale process or extraordinary circumstances.

3. Transactions Free and Clear of Interests

Recommended Principles:

- In general, the trustee should be able to sell a debtor’s assets free and clear of all interests in a debtor’s assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution and the guidelines set forth in these principles. In addition, the trustee should be able to sell a debtor’s assets free and clear of all claims related to a debtor’s assets in the context of a sale of all or substantially all of a debtor’s assets under section 363x (or a transaction involving less than substantially all of the debtor’s assets if the court determines that the trustee has otherwise complied with the requirements of section 363x).
- A trustee should be able to sell assets free and clear of interests if applicable nonbankruptcy law would permit the owner of such assets to sell them free and clear of such interests. The foreclosure rights of a creditor or other third party

⁵²³ For examples of courts considering the finality issue and refusing to reopen auction, see *In re Bigler*, LP, 443 B.R. 101 (Bankr. S.D. Tex. 2010); *In re Extended Stay Inc.*, No. 09-13764 (JMP) (Bankr. S.D.N.Y. June 17, 2010) [Docket No. 1102] (transcript of record); *In re Finlay Enters., Inc.*, No. 09-14873 (Bankr. S.D.N.Y. Nov. 12, 2009) [Docket No. 378] (transcript of record). *But see* *Corporated Assets, Inc. v. Paloian*, 368 F.3d 761 (7th Cir. 2004) (auction reopened due to improper procedures).

should not be determinative in this context. Bankruptcy Code section 363(f)(1) and (5) should be amended accordingly.

- A trustee should be able to sell assets free and clear of interests without the consent of any lienholder and regardless of whether the assets generate value in excess of the aggregate value of the liens in the assets, provided that the liens attach to the proceeds of the sale or the lienholder receives another appropriate form of adequate protection of the lien. Section 363(f)(3) should be amended accordingly.
- In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.
- The court should not approve a sale of a debtor's assets free and clear of the following kinds of interests: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to "run with the land" under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to "run with the land" under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing, or disputed ownership interests, except to the extent specified in section 363(h) or (i).
- The sale of a debtor's assets free and clear of executory contracts and unexpired leases should be governed by section 365 or, for collective bargaining agreements, section 1113. Accordingly, the trustee should be permitted to sell the debtor's assets free and clear of executory contracts and unexpired leases only to the extent such contracts and leases are rejected in accordance with section 365 or section 1113, as applicable, and the trustee is permitted by section 365 to recover the property free and clear of the nondebtor counterparty's rights to use or possess such property.
- The court's approval of a sale free and clear of interests or claims under section 363(f) should continue to be considered part of the court's approval of the overall transaction under section 363(b) or (c). Accordingly, no change to existing law is suggested on this point.
- To the extent permitted by these principles for other claims, the trustee should be able to sell a debtor's assets free and clear of any monetary claims by the federal government or a state government against the debtor or the estate, provided that such monetary claims constitute "claims" under section 101(5) under current law. The trustee should not be able to sell a debtor's assets free and clear of any enforcement rights of such government to the extent that such rights are within such government's police or regulatory powers and could be enforced against the debtor or the estate under section 362(b)(4), or to the extent that the state or federal government incurs costs post-sale in the exercise of its police or regulatory powers.

Transactions Free and Clear of Interests: Background

In many chapter 11 cases, some or all of the debtor's property is encumbered or subject to the liens, interests, and claims of various stakeholders. The holders of these liens, interests, and claims may have rights under nonbankruptcy law or prepetition agreements that make the transfer of the debtor's assets difficult or less attractive to prospective lessees and purchasers. These liens, interests, and claims may include mortgages, security interests, easements, or successor liability claims.

Under section 363(f), a debtor in possession⁵²⁴ may sell its assets under section 363(b) or (c) "free and clear of any interest in such property of an entity other than the estate" only if: (1) "applicable nonbankruptcy law permits sale of such property free and clear of such interest"; (2) "such entity consents"; (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property"; (4) "such interest is in *bona fide* dispute"; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."⁵²⁵ Section 363(f) is limited to "any interest in such property." Notably, this language is different from that used in section 1141(c), which speaks to "property dealt with by the plan [being] free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."⁵²⁶

The legislative history of section 363(f) provides little guidance on the scope of the term "interest," other than to acknowledge that a lien should be considered an interest in property.⁵²⁷ Courts interpreting this section have taken two general approaches: the first construes section 363(f) narrowly and limits its application to liens, security interests, mortgages, and money judgments;⁵²⁸ and the second takes a more expansive view of interests and captures claims against the debtor or estate property, including successor liability claims, discrimination claims, personal injury claims, and other "claims" within the meaning of section 101(5) of the Bankruptcy Code.⁵²⁹ Some courts and commentators argue that the expansive approach is necessary to facilitate sales under section 363(f) and to achieve the underlying policy objectives of the Bankruptcy Code.⁵³⁰

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

525 11 U.S.C. § 363(f).

526 *Id.* § 1141(c).

527 The legislative history provides, in relevant part:

At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale, and if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.

H.R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6302; S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5842.

528 See, e.g., *In re White Motor Credit Corp.*, 75 B.R. 944, 948 (Bankr. N.D. 1987); *In re New England Fish Co.*, 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

529 See, e.g., *In re Trans World Airlines, Inc.*, 322 F.3d 283, 289 (3d Cir. 2003) ("[T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property'" (citing 3 Collier on Bankruptcy ¶ 363.06[1])); *In re WBQ P'ship*, 189 B.R. 97, 105, (Bankr. E.D. Va. 1995).

530 See, e.g., *In re Trans World Airlines, Inc.*, 322 F.3d 282, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of section 363(f) to include claims); *Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV*, 209 F.3d 252 (3d Cir. 2000) (holding that pursuant to section 363(f), the debtors' contractual payment rights was free and clear of a contractor's previously unexercised setoff rights, but was not free and clear of the contractor's recoupment rights because by their very nature, recoupment rights simply cannot be considered an "interest" in property extinguished by a section 363(f) free-and-clear sale"); *In re Tougher Indus., Inc.*, 2013 WL 1276501, at *6 (Bankr. N.D.N.Y. Mar. 27, 2013).

Courts also take different approaches to whether a debtor in possession has satisfied one of the grounds set forth in section 363(f) to support a sale free and clear of interests in the property.⁵³¹ For example, some courts require the sale price to exceed the face value of secured claims asserted against the property to satisfy section 363(f)(3).⁵³² Other courts require only that the sale price exceed the economic value of the creditors' allowed secured claims under section 506.⁵³³ Courts also disagree as to what constitutes a *bona fide* dispute for purposes of section 363(f)(4).⁵³⁴ They also have taken different approaches to whether the language in section 363(f)(5) providing that the "entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest" includes a cramdown of a chapter 11 plan under section 1129(b).⁵³⁵

Transactions Free and Clear of Interests: Recommendations and Findings

The Commissioners analyzed section 363(f) of the Bankruptcy Code and the concept of sales "free and clear" of liens, interests, and claims. They reviewed the original focus of that section on "interests" in estate assets, and they discussed the expansion of that concept to claims of various kinds. The Commissioners identified different kinds of claims that courts have included within section 363(f), including litigation claims, discrimination claims, and successor liability claims. The Commission agreed that this expansive approach to section 363(f) fostered more competition for the debtors' assets and likely enhanced the value of the assets sold through the section 363(f) sale process. The Commissioners questioned whether the historical nexus between "free and clear" sales under section 363(f) and *in rem* notions of property interests still served bankruptcy policy.

To analyze this question, the Commission considered the language and purpose of section 1141(c) of the Bankruptcy Code and the inclusion of claims in the discharge injunction in connection with a chapter 11 plan. The Commissioners suggested that this difference may relate to the more significant notice and due process provided to creditors in the plan process. Although creditors holding general unsecured claims (including the kinds of litigation and other claims mentioned above) do not have any particular interest in the debtor's property, they receive notice and an opportunity to object to the treatment of their claims under the plan. In the section 363 context, such creditors may or may not receive notice of the sale motion or an opportunity to object.

531 See generally George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002).

532 See, e.g., *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008). See also *Criimi Mae Servs., Ltd. P'ship v. WDH Howell, LLC (In re WDH Howell, LLC)*, 298 B.R. 527, 534 (D.N.J. 2003). See also Robert M. Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, Bankr. L. Letter, Oct. 2008, at 7 ("Although the result in *Clear Channel* will be controversial, its specific holding on section 363(f)(3) should not be. Its reasoning is compelling on the statutory language, and it reaches a result well within the mainstream of other court decisions. To sell free and clear under section 363(f)(3), the sales price must exceed the total value of all liens regardless of whether those are totally secured or undersecured.") (citations omitted).

533 See, e.g., *WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (In re WBQ P'ship)*, 189 B.R. 97, 105–06 (Bankr. E.D. Va. 1995); *In re Beker Indus. Corp.*, 63 B.R. 474, 475–76 (Bankr. S.D.N.Y. 1986).

534 See, e.g., *Union Planters Bank v. Burns (In re Gaylord Grain LLC)*, 306 B.R. 624 (B.A.P. 8th Cir. 2004).

535 See, e.g., *Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008). See also Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, *supra* note 532, at 8 ("Instead of the Chapter 11 cramdown, a state foreclosure proceeding would seem to be a proceeding where the second lienholder could be compelled to accept a monetary satisfaction of its lien and thus satisfy the requirements of (f)(5). Indeed, the word 'foreclosure' means exactly that — the foreclosure of junior interests. A hypothetical state foreclosure proceeding seems so obvious that one wonders why the BAP [in *Clear Channel*] did not simply take judicial notice of it to hold that (f)(5) was satisfied. Perhaps the court's concern was the lack of a solid record on how the foreclosure sale process would play out and specifically what value the property would bring at a foreclosure sale, although the bidding at the bankruptcy court would again seem to be an obvious place to look for the value of the property. The concern about the lack of a record perhaps can be seen in the BAP's references to 363 sales being used to bypass the more procedurally robust confirmation requirements of section 1129 that could protect third-party rights.") (citations omitted).

The Commissioners evaluated whether this difference in process should preclude an expansive reading of section 363(f) that would include liens, interests, and claims. With respect to single-asset sales or smaller transactions, the Commission agreed that the notice currently required by the Bankruptcy Rules was likely sufficient, as assets remained in the estate to potentially fund claims through a chapter 11 plan. In a sale of all or substantially all of a debtor's assets, however, the calculus may be different. On that point, the Commissioners noted that these principles recommend notice and due process procedures similar to what creditors are entitled to in the plan context. Accordingly, under the principles applicable to section 363x sales, creditors holding the kinds of claims subject to section 363(f) under the expansive view would receive notice and an opportunity to object to the proposed sale.

The Commissioners were also persuaded that permitting the debtor in possession to transfer clean title to a purchaser under section 363(f) held potentially significant value for the estate. To that end, the Commissioners analyzed the conflicting interpretations of certain subsections of section 363(f) and identified approaches that would foster a competitive sale process while still protecting creditors' rights against the estate. The Commission agreed that the scope of section 363(f)(1) and (5) should be clarified to focus on the property owner's rights under applicable nonbankruptcy law. The Commission also determined, however, that these ambiguities and perceived barriers to free and clear transfers in a chapter 11 case would likely be mitigated by its recommended change to section 363(f)(3). With the additional notice and process being recommended in the context of sales of all or substantially all of the debtor's assets, the Commission determined that adopting an expansive view of section 363(f) was warranted and adequately protected the interests of stakeholders.

The Commissioners further considered whether any particular liens, interests, or claims should be excluded from section 363(f) under this expansive approach. They methodically evaluated different kinds of claims and interests. They decided that the debtor in possession should be able to transfer property free and clear of all liens, interests, and claims, including without limitation: civil rights liabilities; successor liability in tort; and successor liability in contract. The Commissioners also concluded that the debtor in possession should *not* be able to transfer property free and clear of the following: easements, covenants, use restrictions, usufructs, or equitable servitudes that run with the land; environmental liabilities and related social policies that run with the land; successorship liability under federal labor laws; and partial, competing or disputed ownership interests, except to the extent specified in section 363(h) or (i). Moreover, the Commissioners recognized that a debtor in possession should not be able to sell or transfer assets under section 363(f) in a manner that violates or impedes the police or regulatory power of the federal government or a state government to the extent that such government could enforce those rights against the debtor in possession or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code. The Commission thus recommended that section 363(f) recognize the government's police and regulatory powers to the extent such powers would be enforceable under section 362(b)(4).

4. Credit Bidding

Recommended Principles:

- In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

Credit Bidding: Background

A creditor with a perfected lien in the debtor's property has certain rights and remedies against the debtor and property within the creditor's collateral package. Among other things, the secured creditor can credit bid the amount of its allowed claim in any sale of its collateral. A secured creditor's right to credit bid exists under both state law and section 363(k) of the Bankruptcy Code. Section 363(k) provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."⁵³⁶

A credit bid allows the secured creditor to purchase the property constituting its collateral if other bidders are not willing to pay sufficient value or the creditor prefers to possess the collateral in lieu of payment. The secured creditor also does not need to pay any cash for the property at the sale to the extent the allowed amount of its claim is sufficient to cover the price of its winning bid. Rather, the secured creditor can set off its secured claim against the debtor or the property against the purchase price it otherwise would be required to pay the estate.⁵³⁷

Although credit bidding is an integral part of the secured creditors' rights package, it is not without limit. Specifically, section 363(k) allows the court to limit a secured creditor's credit bid for cause.⁵³⁸ Courts typically have found cause to limit a credit bid if the amount of the secured creditor's claim is disputed or unliquidated.⁵³⁹ Courts also have found cause to limit a credit bid, however, based on the conduct of the secured creditor. For example, *In re Free Lance-Star Publishing Co.*, the court held that the secured creditor did not have the right to credit bid on assets that did not secure its allowed claim and found cause to limit the creditor's right to credit bid at the auction based on, among other things, the creditor's "overly zealous loan-to-own strategy," in which the creditor acquired the loan

⁵³⁶ 11 U.S.C. § 363(k).

⁵³⁷ *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (providing historical overview and describing the evolution of credit bidding in bankruptcy), available at Commission website, *supra* note 55.

⁵³⁸ 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

⁵³⁹ See, e.g., *In re RML Dev., Inc.*, 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (valid claims objection that could not be resolved without delaying auction was cause to limit amount of credit bid).

for the sole purpose of obtaining the right to credit bid at an expedited sale of the debtor's assets and discouraged any competitive bidding.⁵⁴⁰ Similarly, in *Fisker Automotive Holdings*, the court found cause to limit the secured creditor's ability to credit bid the entire amount of its secured claim because the amount was uncertain, and allowing the creditor to credit bid its entire claim would freeze out all competitive bidding by attractive and capable bidders.⁵⁴¹

Credit Bidding: Recommendations and Findings

The Commission considered credit bidding under section 363(k) in light of recent case law developments and an arguably expanded application of the cause standard for limiting credit bids. The Commissioners discussed the fundamental role of credit bidding under state law and section 363(k).⁵⁴² They also acknowledged that all credit bidding chills an auction process to some extent. Accordingly, the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).

The Commissioners noted that, in some cases, it may be difficult to discern any chilling effect caused by the credit bid itself from a chilling effect resulting from the conduct of the secured creditor seeking to exercise its right to credit bid. For example, the Commissioners discussed situations in which the secured creditor demands a relatively short period to market the property and conduct the sale, requires the marketing materials to highlight the secured creditor's right to credit bid, or takes other actions to discourage a competitive bidding process. The Commission agreed that such conduct could, in fact, depress the value of the property and preclude the estate from receiving any return from the sale.⁵⁴³ The Commissioners, however, did not want to endorse a principle that would suggest that the chilling effect of a credit bid warrants restrictions on the right to credit bid.⁵⁴⁴ The Commission ultimately agreed to maintain the current standard under section 363(k), with the recommendation that the chilling effect of a credit bid not be deemed sufficient cause to limit a credit bid, but that courts should attempt to mitigate any chilling effect through the auction and sale procedures approved in the case.

540 *In re Free Lance-Star Publ'g Co. of Fredericksburg*, Va., 512 B.R. 798 (Bankr. E.D. Va. 2014), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

541 *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

542 See, e.g., Brubaker, *The Post-RadLAX Ghosts of Pacific Lumber and Philly News*, *supra* note 43, at 3 ("For secured creditors, operating on the assumption that in a free-and-clear sale of its collateral the sale price itself establishes the value of the collateral, credit bidding serves two protective functions — both as an undervaluation protection and a proceeds protection. Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the undersecured creditor the full value of the proceeds generated by sale (*i.e.*, the value) of its collateral."); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, Bankr. L. Letter, July 2012, at 8 ("[T]he legislative record indicates that the Code drafters also considered the credit bidding rights separately codified in § 363(k) to be an integral component of adequately protecting the secured creditor's lien rights."). "By holding that a dissenting secured creditor must be afforded credit-bidding rights under § 363(k) in any free-and-clear sale of its collateral under a plan of reorganization, RadLAX ensures that secured creditors have the same credit-bidding rights in plan sales that they have in § 363 sales." *Id.*

543 See, e.g., Brubaker, *The Post-RadLAX Ghosts of Pacific Lumber and Philly News*, *supra* note 43, at 4 ("When the undersecured creditor's collateral is the entirety of the debtor's assets, therefore, credit-bidding rights in any going-concern sale of the debtor's business and assets give that senior secured creditor the leverage to always insist upon capturing all of the debtor's reorganization surplus, to the detriment of unsecured creditors and other junior classes.").

544 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) ("To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any deep-pocketed bidder, and no auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."), *available at* Commission website, *supra* note 55.

C. Avoiding Powers

1. Preference Claims

Recommended Principles:

- The trustee's ability to pursue preference claims under section 547 of the Bankruptcy Code preserves value for the estate and tempers the "run on the debtor" that may occur immediately prior to a bankruptcy filing. The avoiding power in section 547 may, however, be subject to abuse in certain cases. The Commission analyzed a variety of potential reforms to section 547, including refining elements of, or shifting the burden of proof for, certain defenses under section 547(c). After much research and deliberation, the Commission determined that the potential abuses under section 547 are addressed most effectively through the changes in small preference actions, pleading requirements, and demand requirements described in these principles, and continued judicial oversight in accordance with the Bankruptcy Code.
- The trustee should be precluded from issuing a demand letter to, or filing a complaint against, any party for an alleged claim under section 547 unless, based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c).
- The trustee must plead with particularity factual allegations in the complaint that establish a plausible claim for relief under section 547. In accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), legal conclusions or speculative allegations should not be sufficient to support a preference complaint.
- The dollar amount of the defense against preference claims provided in section 547(c)(9) should be increased to \$25,000 in the aggregate. This dollar amount should continue to be increased based on the *Consumer Price Index for All Urban Consumers* under section 104(a).
- The small claims venue provision in 28 U.S.C. § 1409(b) should be amended to (i) clarify that the section applies to preference actions under section 547 and (ii) increase the dollar limit for debts (excluding consumer debts) against noninsiders to \$50,000 in the aggregate. This dollar amount should continue to be increased based on the *Consumer Price Index for All Urban Consumers* under section 104(a).

Preference Claims: Background

The concept of preference law dates back to the 1584 English King's Bench decision, *The Case of Bankrupts* (finding postpetition transfers ineffective against a bankrupt's estate)⁵⁴⁵ and the 1768 decision of *Alderson v Temple* (authorizing the recovery of property preferred to a particular creditor).⁵⁴⁶ Since that time, the law has undergone numerous variations with regard to the underlying purpose of the transfer, the necessary intent of the parties, and the insolvent state of the debtor at the time of the transfer. In 1978, Congress revised the preference law to omit the requirement that the trustee⁵⁴⁷ establish that the creditor had reasonable cause to believe the debtor was insolvent, in exchange for the reduction of the noninsider reachback period from 120 to 90 days and the addition of a 90-day presumption of insolvency.

The primary goals of preference law are (i) to equalize distribution and (ii) to maximize estate value.⁵⁴⁸ It seeks to achieve these goals through property recapture and deterrence.⁵⁴⁹ Under the Bankruptcy Code's original conception of preference law, the trustee could recover payments or property transferred to creditors prepetition to the extent those transfers preferred such creditors over other similarly situated creditors (typically general unsecured creditors).⁵⁵⁰ The trustee would then distribute the recovered value to all similarly situated creditors. Even the creditors from which the trustee recovered preferences were, in many instances, entitled to receive a *pro rata* share of the recovered value.⁵⁵¹

Since 1978, the application of preference law has changed. Some commentators question whether preference law continues to serve its original goals.⁵⁵² These commentators suggest that preference law is not an effective deterrent and does not necessarily equalize distributions. In fact, anecdotal evidence shows that, in many cases, the value of preference recoveries no longer is reallocated among general unsecured creditors. Rather, secured creditors are granted liens in preference claims and recoveries as part of adequate protection, cash collateral, or debtor in possession financing orders in the case.⁵⁵³ Alternatively, the estate may not have sufficient resources to pay administrative and priority claims in the case, and the trustee applies preference recoveries to these claims.⁵⁵⁴ Moreover,

545 7 Eng. Rep. 441 (K.B. 1584).

546 96 Eng. Rep. 384 (K.B. 1768).

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

548 John C. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 261 (1981).

549 *Id.* at 262.

550 See, e.g., *G.H. Leidenheimer Baking Co., Ltd. v. Sharp (In re SGSM Acquisition Co., LLC)*, 439 F.3d 233, 238 (5th Cir. 2006) ("The theory is that when the preferential payments are returned, all creditors can share ratably in the debtors' assets, and the race to the courthouse, or the race to receive payment from a dwindling pre-bankruptcy estate, will be averted.").

551 For examples of statutory authority for such distributions, see Section 57g of the Bankruptcy Act and section 502(h) of the Bankruptcy Code.

552 See, e.g., Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 Iowa L. Rev. 51 (2014).

553 Terry Brennan, Miller: *Liquidations Set to Rise*, The Deal, Dec. 2, 2003, available at 2003 WLNR 4666298; Kenneth N. Klee & Richard Levin, 21 Norton J. Bankr. L. & Prac. 5, §§ 3.0, 3.6 (Nov. 2012); see Thomas D. Goldberg, *Curbing Abusive Preference Actions — Rethinking Claims on behalf of Administratively Insolvent Estates*, Am. Bankr. Inst. J., May 2004, at 14. Goldberg, *See also In re Furr's Supermarkets, Inc.*, 373 B.R. 691, 697 (B.A.P. 10th Cir. 2007) (proceeds of avoidance actions split between secured lender and administrative claims); *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 294 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (proceeds of avoidance actions used solely to pay claims of secured lenders); *In re Payless Cashways, Inc.*, 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (preference action recoveries solely to satisfy administrative claims).

554 Companies increasingly utilize easy to obtain prepetition financing, through mezzanine funding, leveraged lending, second lien debt, and securitization, such that potential debtors are now contemplating bankruptcy with extremely leveraged balance sheets. As a result, little, if any, unencumbered collateral is often available to offer prospective DIP lenders. See Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept/Oct. 2009, ¶¶ 11–12, available at <http://www.turnaround.org/Publications/Articles.aspx?objectId=11602>. See also Goldberg, *supra* note 553, at 14.

trustees may pursue preference claims in situations in which a cost-benefit analysis indicates little value for the estate, but significant cost and burden for the targeted creditors.

Preference Claims: Recommendations and Findings

Preference law is one aspect of a chapter 11 case that affects creditors on an individual basis. Unlike other aspects of bankruptcy law that generally affect creditors' rights, preference law challenges transfers made to a particular creditor and may require that creditor to disgorge prepetition payments to the estate. The Commissioners acknowledged that from the unsecured creditor's perspective, preference law appears unfair and potentially increases the losses by that particular creditor as a result of the chapter 11 case, particularly if preference recoveries are not available to pay general unsecured claims.

The Commission reviewed the testimony from the various public hearings, which evidenced strong frustrations with preference law. Witnesses testified that some trustees pursued preference actions with little diligence and without regard to the merits of the underlying claim.⁵⁵⁵ They suggested that, at least from an outside perspective, some trustees appear to file preference actions not necessarily to recover the alleged preference, but to extract a settlement payment.⁵⁵⁶ The Commissioners discussed different options for addressing these concerns and enhancing the efficiency of the preference process,⁵⁵⁷ as well as the potential abuses associated with each.⁵⁵⁸

Under section 547 of the Bankruptcy Code, the trustee currently bears the burden of proving the elements of a preference claim under section 547(b), and then the creditor bears the burden of proving one of the affirmative defenses contained in section 547(c). The Commission considered supplementing the elements of section 547(a) with an affirmative statement concerning diligence performed to evaluate the merits of the preference claim in light of any section 547(c) defenses available to the creditor. Alternatively, some of the Commissioners suggested a presumption in favor of the creditor that the prepetition transfer was in the ordinary course of business, which the trustee could rebut as part of its *prima facie* case.⁵⁵⁹ Although the Commissioners found potential utility

⁵⁵⁵ See *Oral Testimony of Kathy Tomlin: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27–29 (May 21, 2013) (NACM Transcript) (noting how she spends tremendous time and resources successfully defending preference actions and arguing that trustees and debtors should have an obligation to evaluate preference claims and defenses before making a repayment demand), available at Commission website, *supra* note 55; *Oral Testimony of Joe McNamara: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 12 (May 21, 2013) (NACM Transcript) (providing specific example of time and costs associated with preference action in a particular case), available at Commission website, *supra* note 55.

⁵⁵⁶ See *Oral Testimony of Valerie Venable: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 34–37 (May 21, 2013) (NACM Transcript) (“The trustee knows [that preference defense] is going to get expensive to me to continue to defend and is counting on a monetary settlement just to get rid of them.”), available at Commission website, *supra* note 55.

⁵⁵⁷ The Commissioners also discussed eliminating the preference statute in its entirety but that principle was rejected. The Commissioners agreed that any such elimination would only accelerate the prepetition depletion of a debtor's assets.

⁵⁵⁸ *In re Ames Dep't Stores, Inc.*, 450 B.R. 24 (Bankr. S.D.N.Y. 2011), *aff'd*, 470 B.R. 280 (S.D.N.Y. 2012), *aff'd*, 506 Fed. App'x 70 (2d Cir. 2012), *cert. denied*, 134 S. Ct. 65 (2013).

⁵⁵⁹ *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 12 (Nov. 15, 2012) (“Since 1978, it has become common in cases of any size that post-confirmation liquidation trustees or post-conversion chapter 7 trustees assert claims against all creditors who received payments from the debtor within 90 days before the commencement of the case that those payments may be avoidable preferences. In some, but not all, such cases, the trustees at least perform new value analyses and claim only the net balance; in virtually no cases do the trustees assess the likelihood of an ordinary course defense. There are usually exchanges of letters and spreadsheets resulting in settlements for a fraction of the amount of the original claims. Often, the creditors settle for nuisance value just to avoid the costs of litigation. This practice imposes costs on creditors vastly disproportionate to the gain to estates, and is particularly difficult for factors who do not have direct access to the original vendors' records. Since factors are a major source of financing for small and medium sized firms, this burden should be of concern to everyone. Requiring the trustees to plead that challenged transfers were not in the ordinary course or subject to new value setoff would reduce the number and burden of weak claims without imposing undue burdens on the trustees. The same records that allow the trustees to identify the payments they question would also allow

in each option, they raised concerns regarding a trustee's ability to obtain information sufficient to make affirmative statements or rebut such a presumption as part of its *prima facie* case. Some of the Commissioners noted that, in many cases, the books and records of the debtor do not provide the information necessary to make these assessments at the outset, and that trustees typically perform due diligence and make good faith attempts to assess the merits of the potential preference action before filing the complaint against, or issuing a demand letter to, the creditor. These Commissioners acknowledged the concerns of the hearing witnesses, but believed those represented the exception rather than the rule concerning a trustee's pursuit of preference claims. The Commission reviewed the steps commonly taken by trustees in evaluating preference claims to try to develop a threshold standard that would not be unduly burdensome on trustees, but also would provide some protection to creditors in the process.

The Commission ultimately determined that codifying a standard that required the trustee to perform reasonable due diligence and to make good faith efforts to evaluate the merits of the preference claim was a reasonable compromise. It also agreed that the statute should require the trustee to plead with particularity in the complaint the facts supporting each element of the preference claim under section 547(b), in accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*,⁵⁶⁰ which provide that legal conclusions or speculative allegations should not be sufficient to support a complaint. Finally, the Commission recommended increasing the monetary caps in section 547(c)(9) of the Bankruptcy Code and section 1409(b) of title 28 of the U.S. Code (the small claims venue provision) to \$25,000 and \$50,000, respectively (indexed in accordance with section 104(a) of the Bankruptcy Code). The Commission voted to recommend these three changes. The Commissioners firmly believed that these changes collectively would mitigate many of the perceived or actual abuses in the preference process.

The Commission also reviewed the potential impact of fee shifting or sanctions in the context of preference litigation. Many of the Commissioners did not support a straight "loser pays" rule, as it could penalize preference defendants in close cases when the claims were disputed and the creditor loses. The Commissioners were also concerned about requiring the estate to pay when the trustee loses on a preference claim because of the nature of preference litigation, which often is uncertain and involves trustees initially working with limited information, and the harm to other beneficiaries of the estate. The Commission determined that neither fee shifting nor sanctions were warranted or workable in the preference context.

2. Recoveries Under Section 550

Recommended Principles:

- The trustee should be permitted to name an alleged subsequent transferee as a defendant in the original complaint to avoid any transfer under Bankruptcy Code section 544, 545, 547, 548, 549, or 553(b), and to recover such property under

them to assess sufficiently for Rule 9011 purposes the ordinary course and new value issues at little additional cost to them. On the other hand, the savings to factors and other creditors that would result from weeding out weak claims before they are even asserted would be substantial."), available at Commission website, *supra* note 55.

⁵⁶⁰ *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007); *Ashcroft v. Iqbal*, 556 U.S. 662 (2009).

section 550. If any alleged subsequent transferee is not named as a defendant in the original complaint, the trustee should be required to sue such transferee in a subsequent action under section 550, and such transferee should have the ability to raise any and all defenses, including those relating to the original avoidance action, in that litigation. Section 550 should be amended accordingly.

- The term “*for the benefit of the estate*” under section 550(a) should be interpreted broadly to permit recoveries for the benefit of “all creditors according to their statutory and contractual entitlements.” *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004). This interpretation of section 550(a) should include all creditors, including administrative claimants and prepetition equity security holders, but should not include lenders under a postpetition financing facility. See Section IV.B, *Financing the Case*. It also should not expand or otherwise affect the underlying causes of action that a trustee must establish prior to seeking recoveries under section 550.
- The trustee should be able to file an action under chapter 5 of the Bankruptcy Code to avoid and recover transfers occurring outside the United States to the same extent it could file such an action with respect to domestic transfers. In reviewing any avoidance action involving transfers occurring solely outside the United States, the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate, considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

Recoveries Under Section 550: Background

Section 550 of the Bankruptcy Code complements the trustee’s chapter 5 avoiding powers by allowing the trustee⁵⁶¹ to recover the property involved in, or the value of, any avoided transfers.⁵⁶² For example, a debtor in possession may avoid preferential transfers under section 547 or fraudulent transfers under section 548 or 544(b) and then seek to recover the security interest, lien, asset, or money transferred in those avoided transactions under section 550. Specifically, section 550(a) provides as follows:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

⁵⁶¹ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁵⁶² 11 U.S.C. § 550.

(2) any immediate or mediate transferee of such initial transferee.⁵⁶³

Section 550 establishes a two-step process: the debtor in possession first files a complaint to avoid the subject transfer or transaction; and then, after the court grants the relief requested by the complaint, the debtor in possession files a separate action to recover the property (or the value of the property) involved in the avoided transfer or transaction. Although the debtor in possession may assert the avoidance action and the recovery action against the transferee in the same complaint, the language of the statute suggests that a separate action must be filed against any subsequent transferees.⁵⁶⁴ Some courts also are uncertain whether a debtor in possession is authorized to seek to recover property from foreign subsequent transferees under section 550.⁵⁶⁵

In addition, courts are divided concerning the interpretation of the phrase “for the benefit of the estate” as used in section 550.⁵⁶⁶ Some courts interpret the phrase broadly, permitting recovery as soon as there is some identifiable benefit to the estate.⁵⁶⁷ Other courts utilize a narrower interpretation, restricting recoveries to those circumstances in which a more direct benefit to creditors (at times, specifically unsecured creditors) can be shown.⁵⁶⁸

The Fifth, Seventh, and Tenth Circuits, as well as certain lower courts within those Circuits, interpret section 550 broadly.⁵⁶⁹ These courts hold that there is a benefit to the estate when *any* interested party in a bankruptcy case stands to benefit from avoidance action recoveries.⁵⁷⁰ The term “interested party” has been interpreted not only to include secured creditors, unsecured creditors, and administrative claimants,⁵⁷¹ but also equity security holders.⁵⁷² In addition, the benefit to the estate does not need to be direct, but may arise indirectly by, for example, increasing the likelihood of effectuating a successful reorganization or meeting payment obligations under a plan.⁵⁷³

⁵⁶³ *Id.*

⁵⁶⁴ *Id.*

⁵⁶⁵ See *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).

⁵⁶⁶ See e.g., *In re Acequia, Inc.*, 34 F.3d 800, 811–12 (9th Cir. 1994).

⁵⁶⁷ *In re C.W. Mining Co.*, 477 B.R. 176, 189 (B.A.P. 10th Cir. 2012), *aff’d*, 749 F.3d 895 (10th Cir. 2014) (explaining that the phrase “for the benefit of the estate,” as used in section 550, should be construed broadly, rather than narrowly, to include indirect benefits). See also *Weaver v. Aquila Energy Marketing Corp.*, 196 B.R. 945, 956 (S.D. Tex. 1996) (noting that section 550’s “benefit” requirement is satisfied as soon as there is some identifiable benefit to the estate).

⁵⁶⁸ See *In re Burlington Motor Holdings, Inc.*, 231 B.R. 874, 877 (Bankr. D. Del. 1999) (holding that “any recovery of preferences in this case will benefit only the Successor Corporation” and that “unsecured creditors must be benefitted by recovery”) (citing *In re Resorts Int’l, Inc.*, 145 B.R. 412, 474–75 (Bankr. D.N.J. 1990)); *Harstad v. First Am. Bank*, 39 F.3d 898, 905 (8th Cir. 1994) (holding that “increas[ing] the likelihood that [debtors] will be able to pay their creditors as the Plan requires, even though it will not increase the amount paid to the creditors” is insufficient benefit to the estate to permit recovery under section 550(a)).

⁵⁶⁹ *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (holding that the term “estate,” as used in section 550(a), means the set of all potentially interested parties, and not any one particular class of creditors); *In re NETtel Corp., Inc.*, 364 B.R. 433, 442 (Bankr. D.C. 2006); *In re Furrs*, 294 B.R. 763, 783 (Bankr. D. N.M. 2003).

⁵⁷⁰ See *MC Asset Recovery LLC v. Commerzbank A.G. (In re Mirant Corp.)*, 675 F.3d 530, 532–34 (5th Cir. 2012); *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004); *In re NETtel Corp., Inc.*, 364 B.R. 433, 442 (Bankr. D. D.C. 2006).

⁵⁷¹ *Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (In re Payless Cashways, Inc.)*, 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (holding that a chapter 11 trustee had standing to pursue preference claims even though recoveries would go solely to satisfy administrative claims).

⁵⁷² See *Kipperman v. Onex Corp.*, 411 B.R. 805, 876–88 (N.D. Ga. 2009) (holding that all interests, including those of all creditors and equity security holders, are comprised in the estate); *In re Bayou Grp., LLC*, 372 B.R. 661, 664 n. 2 (Bankr. S.D.N.Y. 2007) (refusing to adopt a bright-line rule that avoidance actions can never be brought in whole or in part for the benefit of equity security holders).

⁵⁷³ *In re P.A. Bergner & Co.*, 140 F.3d 1111, 1118 (7th Cir. 1998), *cert. denied*, 525 U.S. 964 (1998) (explaining that though preference action recovery will benefit reorganized debtor and thus owners of reorganized debtor, recovery under section 550(a) is permissible because owners of reorganized debtor were the largest creditor group of old debtor, so benefit to these creditors provides a sufficient benefit to the estate to satisfy the requirements of section 550); *In re Furrs*, 294 B.R. 763, 780 (Bankr. D.N.M. 2003) (holding that “an action which will generate funds for the payment of administrative claims is a proper use of [t]rustee’s avoiding and recovery powers”). See also *Weaver v. Aquila Energy Marketing Corp.*, 196 B.R. 945, 956 (S.D. Tex. 1996) (holding that section 550’s “benefit” requirement is satisfied as soon as there is some identifiable benefit to the estate).

Courts narrowly interpreting section 550(a) do not require an absolute direct benefit to unsecured creditors, but they generally require a more direct benefit to those creditors than do courts that employ the broader interpretation.⁵⁷⁴ For example, the Eighth Circuit⁵⁷⁵ and the Bankruptcy Court for the District of Delaware⁵⁷⁶ have interpreted section 550(a) as effectively requiring that the contemplated recovery be somehow targeted, or legally tied, to the benefit of creditors (e.g., pursuant to a plan in which avoidance action proceeds are distributed or in a settlement under Bankruptcy Rule 9019). In both cases, the courts found that the demonstrated benefit was insufficient to permit recovery under section 550(a).⁵⁷⁷

Recoveries Under Section 550: Recommendations and Findings

The Commission reviewed several issues relating to avoidance action recoveries under section 550. This section of the Bankruptcy Code is an integral component of the trustee's avoiding powers under chapter 5 of the Bankruptcy Code. It essentially represents the mechanism by which the trustee can recover any value resulting from avoidance actions for the estate. Recognizing the section's importance in the avoidance process and the need to provide a clear, efficient, and fair path to recoveries, the Commissioners discussed the actual mechanics of section 550.

Several Commissioners commented on the sometimes cumbersome process of suing on the underlying avoidance action and then bringing the recovery action under section 550 after the fact. Many of the Commissioners believed that providing subsequent transferees with at least notice of the underlying avoidance action and an opportunity to intervene would improve this system. This kind of notice would prevent duplicative litigation when no notice is provided, and a subsequent transferee disputes the existence of a valid cause of action. Others suggested requiring the trustee to name any potential subsequent transferees as defendants in the underlying avoidance action. Some of the Commissioners questioned whether such a requirement was feasible, because often the identity of any subsequent transferees is discovered in the litigation on the underlying avoidance claim and is not necessarily known to the trustee at the time of filing the complaint. Notice would not be possible in those cases.

⁵⁷⁴ See, e.g., *In re Acequia, Inc.*, 34 F.3d 800, 811 (9th Cir. 1994) (allowing recovery of fraudulent transfers even though creditors have been paid in full when recovery would aid continuing performance under plan and pay administrative creditors because “[c]ourts construe the ‘benefit to the estate’ requirement broadly, permitting recovery under section 550(a) even in cases where distribution to unsecured creditors is fixed by a plan of reorganization and in no way varies with recovery of avoidable transfers”); *Harstad v. First Am. Bank*, 39 F.3d 898, (8th Cir. 1994) (“We do not hold that a bankruptcy trustee or a debtor in possession (or a debtor or an appointed representative under powers reserved via § 1123(b)(3)) must demonstrate a direct benefit to the creditors in the form of a distribution to the creditors of the preference recovery (although that would certainly make this a much easier issue to decide). Nevertheless, we do hold that those wishing to bring preference actions must show a more definite benefit to creditors than the [debtors] have shown here.”); *Wellman v. Wellman*, 933 F.2d 215, 218 (4th Cir. 1991), *cert. denied*, 502 U.S. 925 (1991) (holding that there is no benefit to the estate “when the result is to benefit only the debtor rather than the estate”); *Adelphia Recovery Trust v. Bank of Am., N.A.*, 390 B.R. 80, 94 (S.D.N.Y. 2008), *aff’d*, 379 Fed. App’x 10 (2d Cir. 2010), *cert. dismissed*, 131 S. Ct. 896 (2011) (“[I]t is well settled in the Second Circuit, that avoiding powers may be exercised by a debtor in possession only for the benefit of creditors, and not for the benefit of the debtor itself.”) (citations omitted) (internal quotation marks omitted); *Trans World Airlines, Inc. v. Travellers Int’l AG (In re Trans World Airlines, Inc.)*, 163 B.R. 964, 972 (Bankr. D. Del. 1994) (“[T]he Code clearly contemplates the use of avoidance action recoveries in the operation of the business in a manner which only indirectly benefits creditors.”).

⁵⁷⁵ *Harstad v. First Am. Bank*, 39 F.3d 898, 904–05 (8th Cir. 1994).

⁵⁷⁶ *In re Burlington Motor Holdings, Inc.*, 231 B.R. 874, 877 (Bankr. D. Del. 1999) (“[The] Plan does not delegate preference recoveries to the estate or list them as a source of funds designated to pay down the Note. Rather, any recovery of preferences in this case will benefit only the Successor Corporation.”).

⁵⁷⁷ See *Harstad v. First Am. Bank*, 39 F.3d 898, 904–05 (8th Cir. 1994); *In re Burlington Motor Holdings, Inc.*, 231 B.R. 874, 877 (Bankr. D. Del. 1999).

Given those obstacles, the Commissioners discussed whether the federal notice standards as articulated by the U.S. Supreme Court in *Mullane v. Central Hanover Bank & Trust Co.* would suffice.⁵⁷⁸ The *Mullane* standard basically requires notice by means “reasonably calculated, under all the circumstances, to apprise the interested parties of the pendency of the action, and afford them an opportunity to present their objections.”⁵⁷⁹ The Commission determined, however, that to the extent the trustee would be seeking to recover value from the subsequent transferees, actual notice should be required. Based on these considerations, the Commission recommended clarifying section 550 to permit the trustee to name a subsequent transferee as a defendant in the original, underlying cause of action and, if not named, to require the trustee to sue the subsequent transferee in a subsequent action, at which time the subsequent transferee should be permitted to assert defenses to the original avoidance cause of action.

The Commissioners then analyzed the extra-territorial application of the trustee’s avoiding powers and recovery rights under section 550 to subsequent transferees. The Commissioners acknowledged the primary competing interests at stake: the perceived unfairness in permitting avoidance of transfers made to parties within the United States, but then precluding that remedy as to any subsequent transferees overseas; and the reasonable expectations of foreign transferees, particularly those who may not know that the transfer originated from the debtor, including the expectation that any payments they received were governed by the laws of their respective jurisdictions. The Commissioners methodically walked through examples when this issue may present itself. They considered situations where a feeder fund is the initial transferee and noted the relevance of the solvency of the feeder fund. They examined the facts of the *Madoff* and *Maxwell* cases and discussed the factual nuances of these cases.⁵⁸⁰ The Commissioners acknowledged and appreciated the delicate balance required in these instances.

The Commissioners discussed how best to balance the competing interests with well-established principles of comity. The Commissioners generally agreed with the notion that foreign transfers should be subject to the chapter 5 avoiding powers, but only if such application was consistent with principles of comity. Accordingly, the Commission approved the recommendation that section 550 cover domestic or foreign subsequent transferees extra-territorially to the same extent as domestic subsequent transferees, but agreed that the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

Once a trustee identifies potential avoidance and recovery actions under chapter 5 of the Bankruptcy Code, courts have differed on whether the trustee may pursue those actions if recoveries will go to stakeholders other than general unsecured creditors. The Commissioners discussed the origins of the concept that avoidance action recoveries should inure only to the benefit of general unsecured creditors and whether such a limited purpose aligned with the concept of the estate.⁵⁸¹ The Commissioners discussed witness testimony that supported limiting the beneficiaries of preference

⁵⁷⁸ *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950).

⁵⁷⁹ *Id.*

⁵⁸⁰ See, e.g., *In re Maxwell Comm’n Corp.*, 93 F.3d 1036, 1047–48 (2d Cir. 1996); *Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC*, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).

⁵⁸¹ See, e.g., *Mellon Bank NA v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (explaining that section 550 “speaks of benefit to the estate — which in bankruptcy parlance denotes the set of all potentially interested parties”).

actions to unsecured creditors. They also considered whether administrative claimants or old equity should be permitted to benefit from recoveries under section 550. The Commissioners drew on the facts and holding in *Mirant Corp.*, in which the Fifth Circuit interpreted section 550(a) and found that “[a] bankruptcy trustee may still have standing to avoid a fraudulent transfer after the unsecured creditors are satisfied in full.”⁵⁸²

The Commissioners found the reasoning of courts following a broader interpretation of section 550(a) to be sound and consistent with the general concept of the bankruptcy estate. The estate does not represent only general unsecured creditors in a case, but often represents a variety of stakeholders whose interests also may have been harmed by improper transfers and transactions subject to avoidance under chapter 5 of the Bankruptcy Code. The Commission voted to endorse a broad interpretation of the term “for benefit of the estate” in section 550(a) to mean all parties with claims against, or interests in, the estate, including administrative claimants and old equity but not including claims of postpetition secured creditors. In reaching this conclusion, however, the Commission agreed that this principle only affected a trustee’s action for recoveries against transferees under section 550; it did not expand or otherwise affect a trustee’s underlying cause of action under section 544, 545, 547, 548, 549, or 553(b).

D. Labor and Benefits

1. Collective Bargaining Agreements Under Section 1113

Recommended Principles:

- Disputes regarding modification and rejection of a company’s collective bargaining agreements can be time-consuming, expensive, and litigious. These disputes also can be emotionally charged and disruptive at key points in the chapter 11 process. Moreover, and perhaps most importantly, they involve a resource many consider critical to a company’s successful restructuring — its employees. Accordingly, the Bankruptcy Code should be amended to further the objectives of negotiation and consensual resolution underlying the collective bargaining process and section 1113.
- To that end, section 1113 should be amended to add requirements that, in addition to the provisions of section 1113(b)(1), the trustee should: (i) provide notice to the applicable labor organization(s) that modifications to the collective bargaining agreement are being proposed along with an initial proposal and description of the information to be made available for the labor organization to evaluate the proposal; and (ii) file a notice of intent to initiate proceedings under section 1113(b)

⁵⁸² MC Asset Recovery LLC v. Commerzbank A.G. (*In re Mirant Corp.*), 675 F.3d 530, 534 (5th Cir. 2012).

and schedule an initial conference with the court regarding such proceedings. The foregoing is intended to promote transparency, disclosure, and communication among the parties, and to provide a reasonable time to conduct negotiations in an effort to reach a consensual agreement prior to the commencement of any litigation by the trustee to reject the collective bargaining agreement. Accordingly, section 1113 should be amended as follows:

- o The trustee should file a request for an initial conference regarding the initiation of section 1113 proceedings with the court and serve the request on the authorized representative of the affected employees (the “*authorized representative*”) and any other party entitled to notice of matters pending in the case under the Bankruptcy Rules. In the request, the trustee should certify that it has provided the authorized representative with a written copy of its initial proposal and the other information required by section 1113(b)(1).
- o The court should set a status conference to discuss the process with the trustee and the authorized representative. This conference should be scheduled so as to allow the authorized representative sufficient time to (i) review the trustee’s notice, initial proposal, and proposed information disclosures; and (ii) meet and confer with the trustee to discuss a timetable for conducting negotiations, any information-related matters, and any other particulars relevant to the conduct of negotiations, including whether the parties believe a mediator would assist in their discussions. The court should conduct the initial conference on or before 30 days after the filing of the trustee’s request for an initial conference.
- o At the initial conference, the trustee and the authorized representative should be prepared to: (i) discuss the timetable for conducting negotiations over the proposal; (ii) resolve any initial issues regarding the disclosure of information relevant for the evaluation of the proposal; (iii) identify any issues regarding the resources available to the parties so that they may engage in informed discussions regarding the request for modifications; (iv) discuss whether the participation of a mediator would assist the parties; and (v) discuss any other issues that may present obstacles to conducting informed, good faith negotiations regarding the trustee’s request for modifications. The court may also wish to establish an expedited process for the resolution of any information-related disputes.
- o If, following a reasonable period of time and consistent with the timetable established at the initial conference (which should take into consideration the nature and scope of the modification proposal), the parties have not reached an agreement regarding mutually acceptable modifications, the trustee may request a further status conference in order for the parties to report to the court regarding the status of the process and for the trustee to request a case management process for a motion to reject the collective bargaining agreement. At such status conference, the court should set a date by which the trustee and the authorized representative would submit

a case management and scheduling order. The proposed hearing schedule may incorporate a bifurcation of the trial into an initial hearing schedule for the presentation of the trustee's case and then, following an adjournment, a second hearing schedule for the authorized representative to present its case. The scheduling order may provide for the (continued) participation of a mediator to facilitate discussions between the parties if requested by the parties or otherwise warranted under the circumstances. The court should schedule the start of the trial on the motion to reject the collective bargaining agreement on or before 180 days after the filing of the trustee's request for an initial conference, unless the trustee and the authorized representative agree to extend, or the court for cause extends, this deadline. The parties should factor this trial deadline into the timetable established at the initial conference.

- o Statutory committees should be able to attend and observe any status conferences conducted under this principle, but participation, including at any hearing on rejection, should be limited to receiving and reviewing information from the trustee and the authorized representative and evaluating the trustee's business judgment regarding the decision to seek rejection under section 1113. Statutory committees would also be heard in the usual manner in connection with any settlement reached between the trustee and the authorized representative.
- o The foregoing recommendations should not be read to, and are not intended to, alter current law with respect to section 1113(e).
- The trustee's rejection of a collective bargaining agreement under section 1113 should be treated as a breach of such agreement. The authorized representative may assert a claim for monetary damages arising from the rejection of the collective bargaining agreement against the estate, on behalf of the affected employees, which claim should be a general unsecured claim, if the rejection order occurs prior to assumption of the agreement, similar to the assertion of rejection damages claims by counterparties to contracts rejected under section 365 pursuant to sections 365(g) and 502(g). Any such rejection damages claims should be determined in accordance with applicable nonbankruptcy law for breach of contract and subject to mitigation.

Collective Bargaining Agreements Under Section 1113: Background

The U.S. Supreme Court's decision in *N.L.R.B. v. Bildisco* resolved disparate rulings among the lower courts regarding the treatment of collective bargaining agreements in bankruptcy.⁵⁸³ In *Bildisco*, the Supreme Court reaffirmed the characterization of a collective bargaining agreement as an executory contract subject to rejection under section 365 of the Bankruptcy Code.⁵⁸⁴ The Supreme Court also

⁵⁸³ *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), *as recognized in* *N.L.R.B. v. Manley Truck Line, Inc.*, 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985).

⁵⁸⁴ *Id.* at 522–23.

held that, in recognition of the “special nature” of a collective bargaining agreement, the debtor in possession’s⁵⁸⁵ proposed rejection of a collective bargaining agreement was subject to a “somewhat stricter standard” of review than the generally applicable business judgment standard.⁵⁸⁶ The Court rejected a very strict standard proposed by the National Labor Relations Board, which was adopted by the Second Circuit in *REA Express*,⁵⁸⁷ i.e., that the debtor in possession should not be permitted to reject a collective bargaining agreement unless it can show that rejection is necessary to prevent the liquidation of the debtor. Instead, the Court endorsed a standard that it viewed as “somewhat higher than that of the ‘business judgment rule’ but a lesser one than that embodied in the *REA Express* opinion.”⁵⁸⁸ The Court also held that a debtor in possession’s unilateral modification of a collective bargaining agreement prior to court approval of the rejection was not an unfair labor practice in violation of the National Labor Relations Act (the “*NLRA*”).⁵⁸⁹

Congress enacted section 1113 of the Bankruptcy Code in direct response to the *Bildisco* decision.⁵⁹⁰ Section 1113 establishes particularized rules regarding the treatment of collective bargaining agreements when an employer is in chapter 11.⁵⁹¹ Among other things, section 1113 establishes special procedures and standards that are applicable when a debtor in possession seeks to modify, or ultimately reject, a collective bargaining agreement. The statute prescribes a process of bargaining between the debtor in possession and the authorized representative of the affected employees as a prerequisite to seeking court-approved rejection. In the absence of an agreed-upon resolution regarding the debtor in possession’s proposed modifications, the debtor in possession may seek court-approved rejection. In doing so, the debtor in possession must meet the rejection standards set forth in the statute in order to obtain court approval, including demonstrating compliance with the statutory bargaining requirements.⁵⁹²

⁵⁸⁵ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁵⁸⁶ *Id.* at 524 (“We agree with these Courts of Appeals that because of the special nature of a collective-bargaining contract, and the consequent ‘law of the shop’ which it creates, [citation omitted] a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement.”).

⁵⁸⁷ *Bhd. of Ry., Airline & Steamship Clerks v. REA Express*, 523 F.2d 164 (2d Cir. 1975).

⁵⁸⁸ See *id.* at 525 (holding that bankruptcy court should permit rejection if “the debtor can show that the collective-bargaining agreement burdens the estate, and that, after careful scrutiny, the equities balance in favor of rejecting the collective bargaining agreement”). The standard adopted by the Supreme Court drew upon the rejection standard proposed by the Eleventh Circuit in *In re Brada Miller Freight Sys., Inc.*, 702 F.2d 890 (11th Cir. 1983).

⁵⁸⁹ *Id.* at 532–33. The Supreme Court’s rationale was that a collective bargaining agreement, like other executory contracts, was not enforceable by the nondebtor party upon the debtor’s bankruptcy filing. The Court’s ruling meant that, where an employer in chapter 11 committed an unfair labor practice by unilaterally modifying a collective bargaining agreement on filing for bankruptcy, statutory remedies under labor law would be unavailing. See 29 U.S.C. § 158(a)(5) (providing that it shall be an unfair labor practice for an employer “to refuse to bargain collectively” with the employees’ authorized representative); *id.* § 158 (d) (establishing the parties’ mutual obligation to bargain collectively, including, among other things, “that no party to [a labor contract] may terminate or modify such contract” absent compliance with the statute’s requirements).

⁵⁹⁰ See *In re AMR Corp.*, 477 B.R. 384, 405–06 (Bankr. S.D.N.Y. 2012) (relating enactment of section 1113 in response to *Bildisco*). See also Andrew B. Dawson, *Collective Bargaining Agreements in Corporate Reorganizations*, 84 Am. Bankr. L. J., 103, 104 (2010) (same).

⁵⁹¹ Section 1113 applies to collective bargaining agreements covered by the National Labor Relations Act, 2 U.S.C. §§ 151–169 (the “*NLRA*”) and to agreements covered by Title II of the Railway Labor Act, 45 U.S.C. §§ 181–188, which is applicable to the airline industry. Railroad collective bargaining agreements covered by Title I of the Railway Labor Act, 45 U.S.C. §§ 151–165, are subject to section 1167 of the Bankruptcy Code. See 11 U.S.C. § 1167.

⁵⁹² In addition to the rejection requirements, and to counteract the Supreme Court’s ruling in *Bildisco* that unilateral modification of a collective bargaining agreement prior to court-approved rejection does not constitute an unfair labor practice, Congress amended section 1113 to prohibit the trustee from unilaterally altering or terminating any provision of a collective bargaining agreement “prior to compliance with the provisions of [section 1113].” 11 U.S.C. § 1113(f). See *Shugrue v. Air Line Pilots Ass’n, Int’l (In re Ionosphere Clubs, Inc.)*, 922 F.2d 984, 990 (2d Cir. 1990), *cert. denied*, 502 U.S. 808 (1991) (reviewing section 1113(f) and concluding that “Congress intended that collective bargaining agreement remain in effect. . . after the filing of a bankruptcy petition unless and until the debtor complies with the provisions of § 1113”). See also *In re Cont’l Airlines*, 125 F.3d 120, 137 (3d Cir. 1997), *cert. denied*, 522 U.S. 1114 (1998) (finding that the “intent behind section 1113 is to preclude debtors or trustees in bankruptcy from unilaterally terminating, altering or modifying the terms of a collective bargaining agreement without following its strict mandate”).

Thus, prior to seeking rejection, a debtor in possession must make a proposal to the authorized representative of the employees that provides relevant information necessary to evaluate the proposal, and meet and confer in good faith with the authorized representative in an attempt to reach a mutually acceptable modification to the labor contract.⁵⁹³ When the parties' efforts do not result in a mutually acceptable modification to the collective bargaining agreement, the debtor in possession may seek court-approved rejection. Under section 1113, the filing of the debtor in possession's motion to reject the collective bargaining agreement requires the court to hold a hearing within 14 days after the filing date, upon at least 10 days' notice to the authorized representative, although the court may extend the time for commencement of the hearing for seven days or for additional periods of time when the debtor in possession and the authorized representative agree.⁵⁹⁴

The statute also sets out the standards for approval of a motion to reject a collective bargaining agreement. Under section 1113(c), the court may approve the motion to reject if the court determines that: (i) the debtor in possession complied with the statutory requirements attendant to making its proposal; (ii) the authorized representative refused to accept the debtor in possession's proposal "without good cause"; and (iii) "the balance of the equities clearly favors rejection."⁵⁹⁵ In evaluating the "balance of the equities" standard, courts have articulated certain factors to be considered.⁵⁹⁶ Section 1113 requires that the court enter a ruling on the motion to reject within 30 days of the date of the commencement of the hearing, unless the parties consent to an extension of this period.⁵⁹⁷ Although an early division in the interpretation of the rejection standard occurred when the Second and Third Circuits issued divergent rulings on the application of the "necessary" and "fair and equitable" standards applicable to the debtor in possession's proposal under section 1113(b)(1),⁵⁹⁸ a study by Professor Andrew Dawson suggests that the difference in interpretation has not appeared to impact the courts' ultimate rulings — courts have generally approved the debtor in possession's motion to reject under section 1113(c).⁵⁹⁹

593 See *In re Pinnacle Airlines Corp.*, 483 B.R. 381, 404–05 (Bankr. S.D.N.Y. 2012) (describing general operation of section 1113). The particular requirements regarding the proposal, provision of information, and good faith negotiations are set forth in section 1113(b)(1)(A) (standards for proposal), section 1113(b)(1)(B) (requirement to provide "relevant information as is necessary to evaluate the proposal"), section 1113(b)(2) (requirement that trustee meet with authorized representative and "confer in good faith in attempting to reach mutually satisfactory modifications"). 11 U.S.C. § 1113(b).

594 See 11 U.S.C. § 1113(d)(1). Section 1113 requires the court to rule on a section 1113 motion to reject within 30 days of the date of the commencement of the hearing, unless the parties consent to an extension of this period. 11 U.S.C. § 1113(d)(2).

595 *Id.* § 1113(c). The debtor bears the burden of proof on the elements of a section 1113 motion to reject. See *Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 88 (2d Cir. 1987).

596 See *e.g.*, *Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 93 (2d Cir. 1987) (detailing six factors to be considered in evaluating the balance of the equities).

597 In addition to the procedures set forth in section 1113(b) through (d), section 1113 also provides for emergency "interim relief" whereby a court may authorize a debtor to make interim changes to wages, benefits, or work rules under the collective bargaining agreement "if essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate." 11 U.S.C. § 1113(e). See *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am.*, AFL-CIO-CLC, 791 F.2d 1074, 1088 (3d Cir. 1986) (explaining that, in enacting section 1113, "Congress recognized that there might be immediate problems of an emergency nature in individual cases" and therefore provided for "interim changes" if the court finds "that an interim change is essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate") (citations omitted). See also 7 Collier on Bankruptcy ¶ 1113.02[3] (describing interim relief provision and "high standards" generally applied to requests for such relief); *In re Salt Creek Freightways*, 46 B.R. 347, 349–50 (Bankr. D. Wy. 1985) (explaining enactment of section 1113(e)).

598 See 11 U.S.C. § 1113(b)(1)(A). Compare *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am.*, AFL-CIO-CLC, 791 F.2d 1074, 1088–89 (3d Cir. 1986) with *Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 89 (2d Cir. 1987).

599 See, *e.g.*, Dawson, *supra* note 590, at 104 (collecting data on how courts interpret the factor that the proposal be "necessary to the reorganization of the debtor" and concluding that "[b]ased on data from every large publicly traded company bankruptcy between 2001 and 2007, the present study reveals that the outcome of [section] 1113 motions was the same regardless of the legal standard applied: the court granted the debtor's motion to reject its CBA").

Collective Bargaining Agreements Under Section 1113: Recommendations and Findings

For debtors with a unionized workforce, the treatment of their labor contracts may represent one of the most important and difficult decisions in the chapter 11 case.⁶⁰⁰ These contracts represent the company's obligations to its employees and are an integral component of the company's relationship with its employees. These contracts, however, also may impose monetary obligations on the company that it no longer can sustain in light of financial distress and its need to reorganize.⁶⁰¹ The Commission appreciated fully the crucial considerations and potentially dynamic elements in the collective bargaining process in a chapter 11 case. In particular, the Commissioners noted that labor relations following rejection should be taken into consideration in utilizing section 1113: even if a collective bargaining agreement is ultimately rejected through the section 1113 process, the company remains obligated to continue to bargain with the authorized representative over modifications to the agreement.⁶⁰²

Most of the testimony received by the Commission on section 1113 issues concerned the bargaining process itself and the deadlines imposed by this section.⁶⁰³ Witnesses expressed concern that the statutory requirements did not, in practice, foster meaningful negotiations.⁶⁰⁴ Rather, some witnesses suggested that many debtors in possession viewed the bargaining required under the Bankruptcy Code as a means to the litigated end they desired.⁶⁰⁵ The Honorable Stephen Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia (whose cases included the *US Airways*

⁶⁰⁰ *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13–14 (Mar. 14, 2013) (ASM Transcript) (“I have to say at the outset that I thought that the decisions I had to make in terms of termination of pension plan or termination of retiree benefits or modification of a collective bargaining agreement or proving interim changes to a collective bargaining agreement were some of the toughest I’ve had to make as a judge . . . I could tell you in no other matters that have come before me in 16 years on the bench that I receive so much mail in chambers and they were profoundly affecting. I mean, I fully understood that for some people it means they themselves might end up having to file up for bankruptcy because necessary financial support was being taken away from them.”), available at Commission website, *supra* note 55.

⁶⁰¹ *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Mar. 14, 2013) (acknowledging that there is a need for labor representatives to make meaningful economic concessions for employers to survive), available at Commission website, *supra* note 55.

⁶⁰² See e.g., *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 534 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), as recognized in *N.L.R.B. v. Manley Truck Line, Inc.*, 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985) (noting that debtor in possession remains obligated to bargain collectively with labor organization following formal approval of rejection).

⁶⁰³ *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Mar. 14, 2013) (“[T]he expedited schedule mandated under Section 111 creates tremendous downward pressure on wages and working conditions. . . . [T]he 1113 process has become in practice a rushed 51-day countdown to destruction of their agreements.”), available at Commission website, *supra* note 55.

⁶⁰⁴ See *Oral Statement of Bob Keach: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Mar. 14, 2013) (ASM Transcript) (“The predominance of Section 363 sales of substantially all the assets of debtors means that often the purchaser do not assume collective bargaining agreements or pension liabilities. This has particularly challenged the statutory regime for addressing such agreements and liabilities.”), available at Commission website, *supra* note 55; *Oral Testimony of Robert Roach Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 51 (Mar. 14, 2013) (ASM Transcript) (“In normal contract negotiations there’s give and take, there’s talking and there’s a result at the end of it. . . . When you bargain on 1113 after a period of time, and it’s two weeks and a week after they file, it’s either you accept what the company gives you or you don’t have a collective bargaining agreement.”), available at Commission website, *supra* note 55. “Negotiation is you come in with a position and both sides are compromised. There is no need for the corporation to compromise in the chapter 1113 proceeding.” *Id.* at 58.

⁶⁰⁵ See *Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript) (“Bankruptcy should only be used as a last resort. Instead . . . companies . . . are routinely placed in bankruptcy solely as a means to escape obligations and reward top executives and middle managers for simply executing a bankruptcy plan.”), available at Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript) (stating that the debtor (company) essentially had a gun to labor’s head — it was a take it or leave it proposition, not a negotiation), available at Commission website, *supra* note 55.

bankruptcy cases) also testified that the statutory deadlines simply did not work, particularly the 14-day hearing requirement.⁶⁰⁶

The Commission considered whether refinements to the statutory process would better serve the goals of the statute. Section 1113(b)(2) provides: “During the period beginning on the date of the making of a proposal provided for in paragraph (1) and ending on the date of the hearing provided for in subsection (d)(1), the trustee shall meet, at reasonable times, with the authorized representative to confer in good faith in attempting to reach mutually satisfactory modifications of such agreement.” Thus, with respect to the bargaining process, section 1113 does not provide any minimum period during which the parties must engage in good faith bargaining.⁶⁰⁷ A debtor in possession could, consistent with the statute, serve a proposal and then, subject only to the requirements of proof set forth in section 1113(c), file a rejection motion quite soon thereafter. The motion would then be subject to the statutory hearing and notice schedule.

Courts and commentators have emphasized that an important goal of section 1113 is to encourage negotiated resolutions when a debtor in possession seeks modifications to its collective bargaining agreements and when litigation should be a last resort.⁶⁰⁸ And, as one court has explained, the amount of time to be allowed for negotiations “must depend on the facts and circumstances of each case.”⁶⁰⁹

The Commissioners discussed these perspectives and whether the requirements currently provided in section 1113(b) were sufficient to generate a meaningful dialogue between the debtor in possession and the authorized representative. The Commissioners generally agreed that the effectiveness of section 1113 was case dependent, but some suggested the process could be improved by more clearly separating the bargaining and the litigation processes. These Commissioners noted that the current process often placed the bargaining and the potential litigation on parallel tracks that had the parties trying to reach a compromise while the debtor in possession was preparing its case to support, and the authorized representative was working to identify good cause to block, the rejection of the agreement. These Commissioners also agreed with the witness testimony that bargaining under

606 *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 13–17 (Mar. 14, 2013) (ASM Transcript) (“Section 1113 and 1114 relief actually require that the judge hold a hearing within 14 days. . . . In reality there were no 14-day hearings or even 21-day hearings in the matters that came in front of me. Everybody understood that there had to be a certain amount of discovery, we [review] the underlying financials, there are opportunities to depose each side’s experts and things like that.”), available at Commission website, *supra* note 55.

607 *See, e.g., Oral Testimony of Robert Roach, Jr., ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 25 (Mar. 14, 2013) (ASM Transcript) (stating that the current good faith negotiation requirement in section 1113 “is not adequate because negotiating in good faith just means coming to the table and talking, it doesn’t mean give or take. . . . [There may be] back and forth, but . . . no negotiation”), available at Commission website, *supra* note 55.

608 *E.g., N.Y. Typographical Union No. 6 v. Maxwell Newspapers, Inc. (In re Maxwell Newspapers, Inc.)*, 981 F.2d 85, 90 (2d Cir. 1992) (explaining that the statute’s “entire thrust” is to “ensure that well-informed and good faith negotiations occur in the market place, not as part of the judicial process”); Dawson, *supra* note 590, at 119 (noting that the statutory “text clearly indicates that Congress preferred the outcome of negotiated settlements to labor disputes”). *See also In re Century Brass Prods., Inc.*, 795 F.2d 265, 273 (2d Cir. 1986), *cert. denied*, 479 U.S. 949 (1986) (finding that section 1113 “encourages the collective bargaining process as a means of solving a debtor’s financial problems insofar as they affect its union employees”); *In re Hostess Brands, Inc.*, 477 B.R. 378, 382 (Bankr. S.D.N.Y. 2012) (“[Section 1113’s] unique purpose is . . . to provide for expedited, good faith bargaining and, ultimately, a determination by the court, if that doesn’t occur.”); Richard H. Gibson, *The New Law on Rejection of Collective Bargaining Agreements in Chapter 11: An Analysis of 11 U.S.C. § 1113*, 58 Am Bankr. L. J. 325, 327 (1984) (reviewing the statute and legislative history and describing principal purpose to “discourage both unilateral action by the debtor and recourse to the bankruptcy court”). “Instead, the law seeks to encourage solution of the problem through collective bargaining.” *Id.*

609 *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC*, 791 F.2d 1074, 1093–94 (3d Cir. 1986) (noting that the need for haste, in and of itself, is not a determining factor, citing the interim relief provision under section 1113(e) which is available to address emergency situations).

section 1113 could be shallow and perceived as a formality in the process.⁶¹⁰ Other Commissioners disagreed with this characterization of the process, but acknowledged the benefit to all parties of a more effective and efficient process.

The Commissioners then analyzed improving the current framework under section 1113. They recognized the delicate balance between encouraging meaningful negotiations and allowing the debtor in possession to move to litigation when necessary. To evaluate potential reforms to the section 1113 process, the Commissioners reviewed practices that have been employed in many chapter 11 cases, in which the parties opted for case management procedures in lieu of the statutory scheduling requirements, and have identified certain “best practices” from these cases. Their discussion focused on the realities of chapter 11 practice — as suggested by Professor Dawson’s study, the debtor in possession usually can prevail on the motion to reject, but that result typically is not in the best interests of the debtor or its employees. Rather, a consensual resolution typically is in the best interests of both parties; it can avoid potential ill will between the parties, lost production for the debtor, and hardship for its employees.

The Commissioners proposed a more structured process for exchanging information and establishing the parameters of bargaining. The Commissioners debated whether the court should be involved in the process from the outset. The Commission determined that requiring an initial status conference with the court would encourage meaningful disclosures and discussions earlier in the process. In this context, it also considered the mandatory appointment of a mediator to help the parties reach a potential resolution more quickly. The Commissioners perceived value in the mediator’s role, but expressed concerns regarding costs and a one-size-fits-all approach to a mediator. They believed that a mediator likely would be an asset in many cases, but believed it would be a more effective tool if invoked based on the facts of the particular case.⁶¹¹

Under the principles adopted by the Commission, there would be an initial conference that would follow disclosure of the proposal by the debtor in possession to the authorized representative and a notice to parties in the case of the debtor in possession’s intention to seek modifications to a collective bargaining agreement by commencing a section 1113 process. The Commission determined that, at an initial conference with the court, the parties should discuss their bargaining timeline, any issues regarding disclosures made by the debtor in possession regarding its proposal, and any potential barriers to meaningful, good faith negotiations. It did not believe that the statute should establish specific deadlines for negotiations. Instead, it wanted the parties and the court to have flexibility under the general guidance that the bargaining parties have reasonable time to engage in meaningful, good-faith negotiations.

610 *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 58 (Mar. 14, 2013) (ASM Transcript), available at Commission website, *supra* note 55; *Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript), available at Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript), available at Commission website, *supra* note 55.

611 *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (stating that whether a mediator would be helpful depends on the circumstances of the case), available at Commission website, *supra* note 55; *Oral Testimony of James Campbell Little, Jr.: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (noting that mediators are not a panacea and that the utility of a mediator will vary by case, by mediator, etc.), available at Commission website, *supra* note 55.

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The Commissioners also discussed an appropriate trigger for permitting a debtor in possession to proceed to litigation to reject the agreement. They compared a trigger similar to one proposed by labor-backed legislation (*i.e.*, the NLRA standard), based upon standards under nonbankruptcy labor law requiring an employer to bargain to “impasse” prior to unilateral implementation,⁶¹² and the alternative of imposing an outside deadline based only on the passage of time. Although the Commissioners understood labor’s preference for the NLRA standard, many of the Commissioners believed that the debtor in possession needed certainty as to when the case could move forward if a consensual resolution was not forthcoming. These Commissioners noted that the impasse standard could stall a debtor in possession’s restructuring efforts indefinitely to the detriment of the debtor in possession and its other stakeholders (and arguably the employees as well). After considering various triggers, the Commission voted to recommend that the procedures incorporate an outside date for the start of the trial on the debtor in possession’s motion to reject within 180 days of the debtor in possession’s request for an initial conference. The Commissioners noted specifically that the forgoing recommended principles regarding the new case management procedures applied only when a debtor in possession pursued relief under section 1113(b), (c), or (d), and that the principles were not intended to change the current law under section 1113(e) applicable to a debtor in possession’s request for interim, emergency relief.

In developing the principles for the enhanced case management process, the Commission also considered whether and to what extent other parties in interest should participate in the section 1113 proceedings.⁶¹³ For example, some of the Commissioners suggested that a statutory unsecured creditors’ committee should be permitted to participate in the process. Others noted that the committee is not a party to the agreement and raised concerns about introducing third parties into the negotiation process.⁶¹⁴ The Commission settled on the approach used in the *Delphi* chapter 11 case, where, in ruling on a motion to limit participation in the section 1113 proceedings, the court determined that certain parties, including the statutory unsecured creditors’ committee, could participate in the section 1113 process solely with respect to asserting a position regarding the debtor in possession’s business judgment in seeking section 1113 relief and not with respect to whether the section 1113 factors had been met.⁶¹⁵ The Commission found persuasive the *Delphi* court’s distinction between the role of the statutory committee in fulfilling its due diligence obligations regarding the debtor in possession’s business judgment to pursue the rejection motion, as a non-ordinary course action by the debtor in possession, and the particulars of the bargaining process and related section 1113 factors, which are matters that should be left to the debtor in possession and the authorized representative both in terms of their negotiations and litigation regarding the debtor in possession’s proposal and related bargaining.

612 See *The Protecting Employees and Retirees in Business Bankruptcies Act of 2013*, H.R. 100, 113th Cong. § 102 (1st sess. 2013) (proposing that a debtor may file a motion to reject a collective bargaining agreement, if, after a period of negotiations, the debtor and labor representative have not reached agreement on modifications “and further negotiations are not likely to produce mutually satisfactory modifications”). See also *N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 533 (1984) (describing “impasse” requirement under the NLRA).

613 See 11 U.S.C. § 1113(d)(1) (providing that, at a hearing on the motion to reject a collective bargaining agreement, “[a]ll interested parties may appear and be heard at such hearing”). The Seventh Circuit has held that section 1113(d)(2) limits the participants—the parties who are authorized to modify the agreement (and any guarantor of the agreement)—to the debtor and the applicable bargaining representative(s) of the affected employees. *In re UAL Corp.*, 408 F.3d 847 (7th Cir. 2005).

614 See, e.g., *Oral Testimony of David R. Jury: ACB Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 23 (Mar. 14, 2013) (ASM Transcript) (“Collective bargaining is a relationship that in most cases long predated the filing of the petition and if the parties are successful will continue long after the bankruptcy case closes. On the other hand, creditor’s committees [are transient]. It came into existence with the case, it will go out of existence with the end of the case.”), available at Commission website, *supra* note 55.

615 *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. May 9, 2006) (oral decision).

The Commission also considered the consequences of the rejection of a collective bargaining agreement; specifically, does rejection give rise to a rejection damages claim, and if so, how should the claim be determined? The Commissioners discussed the current split in the case law regarding rejection damages under section 1113. One court decision, *In re Blue Diamond Coal Co.*, held that rejection damages were unavailable under section 1113 as a matter of statutory construction.⁶¹⁶ The *Blue Diamond* court's view was that section 1113 completely removed collective bargaining agreements from the provisions of section 365 of the Bankruptcy Code.⁶¹⁷ Other courts have disagreed with the *Blue Diamond* analysis of section 1113 and its relationship to section 365 and other provisions of the Bankruptcy Code, and instead have interpreted sections 1113 and 365 as working in tandem, thus permitting the assertion of rejection damages claims for the rejection of collective bargaining agreements under section 1113. As one court has explained, "[s]ection 1113 is designed to provide additional procedural requirements for rejection or modification of collective bargaining agreements, and only to that degree supersedes and supplements the provisions in § 365."⁶¹⁸

The Commissioners also noted the discussion by the court in *Northwest Airlines*.⁶¹⁹ In this decision, the court labeled the effect of rejection as an "abrogation" of the agreement rather than a breach of the agreement, thus calling into question whether an order granting rejection could give rise to a claim for rejection damages. The Commissioners were persuaded by the reasoning and results of courts interpreting section 1113 as supplementary to section 365, as well as the practicalities of the availability of a rejection damages claim in reaching a resolution. The Commission voted to recommend that section 1113 be amended to clarify that rejection of a collective bargaining agreement constitutes a breach of the agreement as of the time of rejection, and that a claim for rejection damages may be asserted. The Commissioners also discussed how such claims would be determined. First, the Commission determined that, like damages claims asserted by nondebtor parties to contracts rejected under section 365, such claims would be general unsecured claims where rejection occurs prior to assumption of a collective bargaining agreement.⁶²⁰ In addition, the Commission agreed that, generally, such claims would be based on the difference between the reductions implemented following rejection and the collective bargaining agreement terms prior to rejection, akin to a breach of contract claim under federal labor law, noting specifically that to the extent actual mitigation of damages by particular employees would apply to such claims, such mitigation would similarly apply to a rejection damages claim.⁶²¹

616 *In re Blue Diamond Coal Co.*, 147 B.R. 720 (Bankr. E.D. Tenn. 1992), *aff'd*, 160 B.R. 574 (E.D. Tenn. 1993).

617 See Michael St. Patrick Baxter, *Is There a Claim For Damages from the Rejection of a Collective Bargaining Agreement Under Section 1113 of the Bankruptcy Code?*, 12 Bankr. Dev. J. 703 (1996) (reviewing *Blue Diamond* decision).

618 *Mass. Air Conditioning & Heating Corp. v. McCoy*, 196 B.R. 659, 663 (D. Mass. 1996) (citing *Norfolk and Western Railway Co. v. Am. Train Dispatchers Ass'n*, 499 U.S. 117, 136 n. 2 (1991) (Stevens, J., dissenting)). See also *In re Moline Corp.*, 144 B.R. 75, 78 (Bankr. N.D. Ill. 1992) (ruling that section 365 operates to fill in the gap left in section 1113 regarding rejection damages and that such omission was a legislative error); Baxter, *supra* note 617 (concluding that section 365 continues to apply except to the extent inconsistent with section 1113 and that section 365(g) applies to permit a claim for rejection damages).

619 *Nw. Airlines Corp. v. Ass'n of Flight Attendants (In re Nw. Airlines Corp.)*, 483 F.3d 160 (2d Cir. 2007).

620 The allocation of a rejection damages among affected employees generally is handled in the context of the proof of claim filed by the authorized representative, but different procedures have been applied depending on the circumstances. See *In re U.S. Truck Co., Inc.*, 89 B.R. 618 (E.D. Mich. 1988) (basing allocation on union's proof of claim). The Commission's recommendation on rejection damages under section 1113 does not affect these various approaches to allocation.

621 See *id.* at 625 (overruling objections to union claim for rejection damages and, where employer based need for rejection on ability to continue operation of the business, allowing union's claim to be calculated as the difference between reductions in compensatory terms and other monetary terms implemented post-rejection and terms under nonrejected collective bargaining agreement, based on analogy to claim under federal labor law for unilateral breach of collective bargaining agreement).

2. Retiree Benefits and Section 1114

Recommended Principles:

- The trustee should comply with the requirements of section 1114 of the Bankruptcy Code for all retiree benefits (as defined in section 1114(a)), even if the trustee contends that such benefits are terminable at will under the terms of the benefit plan or applicable nonbankruptcy law. The trustee's compliance with section 1114 for benefits that the trustee contends may be terminable at will should not create any new claims on behalf of retirees or otherwise affect the existence, nature, or scope of any retirees' claims upon the termination or modification of such benefits in accordance with section 1114, which claims should be determined consistent with the terms of the plan or applicable nonbankruptcy law.

Retiree Benefits and Section 1114: Background

Section 1114 requires the debtor in possession⁶²² to timely pay any retiree benefits and to follow a notice, disclosure, and bargaining process before seeking to modify any retiree benefits during the chapter 11 case. It also provides administrative priority for payments of retiree benefits required to be made before the effective date of a confirmed plan.⁶²³ The protections afforded retiree benefits under section 1114 are supplemented by a corresponding plan confirmation requirement under section 1129(a)(13). Section 1114 defines the term “*retiree benefits*” as “payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title.”⁶²⁴

With respect to the modification of retiree benefits, the section 1114 process resembles the section 1113 process for the rejection of collective bargaining agreements, with at least one key difference.⁶²⁵ Under section 1114, a committee authorized by the court to serve as an “authorized representative” of such retirees will represent retirees who are receiving benefits not covered by a collective bargaining agreement in the section 1114 process.⁶²⁶

As suggested above, the term “retiree benefits” is broad and covers such payments under any prepetition “plan, fund, or program (through the purchase of insurance or otherwise) maintained or established” by the debtor. In fact, some courts interpret this language to include payments under a prepetition retiree benefit plan even if the debtor contends that it has expressly reserved the right

⁶²² As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁶²³ 11 U.S.C. § 1114(e).

⁶²⁴ 11 U.S.C. § 1114(a).

⁶²⁵ See *In re Farmland Indus., Inc.*, 294 B.R. 903, 918 (Bankr. W.D. Mo. 2003) (“A consideration of § 1113 of the [Bankruptcy] Code provides further support for the Court’s understanding of § 1114.”).

⁶²⁶ 11 U.S.C. § 1114(b)(1), (2), (d). The union under the collective bargaining agreement that gave rise to the retiree benefits presumptively serves as the authorized representative for retirees receiving such benefits. 11 U.S.C. § 1114(c).

to unilaterally terminate or modify such plan at any time.⁶²⁷ For example, in *Visteon*, the relevant plan documents provided that “the Company reserves the right to suspend, modify or amend the benefits provided under the Plan, or even terminate the Plan or any of the benefits provided under the Plan. . . . [T]his handbook is not a contract, nor is it a guarantee of your coverage.”⁶²⁸ The Third Circuit adopted a strict reading of the statute and determined that “[t]he fact that the debtor could have unilaterally stopped the payments had it not been in chapter 11 is . . . irrelevant.”⁶²⁹ Nevertheless, other courts have ruled that a debtor in possession is not required to comply with the section 1114 process when the debtor in possession establishes that it has the right under the prepetition program of benefits to unilaterally modify or terminate the benefits.⁶³⁰

Retiree Benefits and Section 1114: Recommendations and Findings

Bankruptcy Code sections 1114 and 1129(a)(13) evidence a strong policy preference for protecting the rights of retirees in a debtor in possession’s chapter 11 case. Section 1114 was enacted in response to the *LTV Steel Company* chapter 11 case in which the debtor in possession announced its intention to discontinue health benefits for approximately 70,000 retired employees immediately upon the petition date on the basis that such benefits would be considered prepetition claims.⁶³¹ The Commissioners understood the history behind section 1114 and the special protections afforded retirees under the Bankruptcy Code. They also observed that retiree issues, when present in a chapter 11 case, can create complex and challenging issues for the debtor in possession.

The Commissioners discussed the current split in the case law regarding whether the section 1114 procedures apply to all prepetition retiree benefit plans, including those that were found to be terminable at will by the debtor outside of bankruptcy. The Commissioners acknowledged the plain meaning interpretation of section 1114 endorsed by the Third Circuit in *Visteon*. They discussed the focus of this decision on the application of section 1114 during the pendency of the chapter 11 case. As the Third Circuit explained in discussing the treatment of retiree benefits under a chapter 11 plan, “the duration of the period the debtor has obligated itself to provide such benefits plainly encompasses *any* durational obligations, including those arising outside of the bankruptcy context.”⁶³² Accordingly, even if bound by the section 1114 process during the chapter 11 case, the reorganized

627 See, e.g., *IUE-CWA v. Visteon Corp.* (*In re Visteon Corp.*), 612 F.3d 210, 219–20 (3d Cir. 2010) (“Section 1114 could hardly be any clearer. It restricts a debtor’s ability to modify *any* payments to *any* entity or person under *any* plan, fund, or program in existence when the debtor files for Chapter 11 bankruptcy, and it does so notwithstanding any other provision of the [B]ankruptcy [C]ode.”); *In re Farmland Indus., Inc.*, 294 B.R. 903, 914 (Bankr. W.D. Mo. 2003) (“In this court’s view, §1114 prohibits a debtor from terminating or modifying any retiree benefits (as defined in that section) during a Chapter 11 case unless the debtor complies with the procedures and requirements of §1114, regardless of whether the debtor has a right to unilaterally terminate benefits.”). See also *IUE-CWA v. Visteon Corp.* (*In re Visteon Corp.*), 612 F.3d 210, 227 (3d Cir. 2010) (explaining legislative history indicating a desire to protect “the ‘legitimate expectations’ of retirees, and the necessity in a ‘just society’ of giving effect to those expectations wherever possible”); S. Rep. No. 100-119, at 1–2 (1987), reprinted in 1988 U.S.C.C.A.N. 683, 684 (“[T]o provide additional protections for the insurance benefits of retirees, their spouses and dependents, of debtors under the Bankruptcy Code”).

628 *IUE-CWA v. Visteon Corp.* (*In re Visteon Corp.*), 612 F.3d 210, 213 (3d Cir. 2010).

629 *Id.* at 222.

630 See, e.g., *In re Gen. Motors Corp.*, No. 09-50026, Hr’g Tr. at 109:24-110:2 (Bankr. S.D.N.Y. June 25, 2009) (“Section 1114 doesn’t apply to employee benefit plans that are terminable or amendable unilaterally by the plan sponsor.”); *In re Delphi Corp.*, 2009 WL 637259, at *19 (S.D.N.Y. Mar. 11, 2009) (“[I]f, in fact, the debtors have the unilateral right to modify a health or welfare plan . . . the debtors’ pre-Bankruptcy rights [are not] abrogated by the requirements of section 1114.”); *In re N. Am. Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002); *Retired W. Union Employees Ass’n v. New Valley Corp.* (*In re New Valley Corp.*), 1993 WL 818245 (D.N.J. Jan. 28, 1993); *In re Doskocil Cos. Inc.*, 130 B.R. 870 (Bankr. D. Kan. 1991).

631 See *In re Chateaugay Corp.*, 64 B.R. 990, 992 (S.D.N.Y. 1986); 133 Cong. Rec. H8558 (daily ed. Oct. 13, 1987) (“[T]he triggering event for [enacting § 1114] was [the] bankruptcy of LTV Steel. . .”).

632 *IUE-CWA v. Visteon Corp.* (*In re Visteon Corp.*), 612 F.3d 210, 224 (3d Cir. 2010) (citations omitted) (internal quotation marks omitted).

debtor could exercise any applicable contractual or nonbankruptcy law rights after the bankruptcy. The Commissioners also noted certain procedural advantages provided by the statute, including the designation of a statutory authorized representative for retirees to engage in the process.

The Commissioners weighed the *Visteon* approach against several competing considerations. For example, courts finding that certain retiree benefit plans fall outside the scope of section 1114 and rely heavily on the parties' prepetition nonbankruptcy rights. Some commentators have noted the practical appeal to this approach given that, even under *Visteon*, the debtor in possession presumably could pay retiree benefits during the case and then, as a reorganized debtor, terminate or modify those benefits immediately after the case, provided that the prepetition benefit plan was found to support a reservation of that right for the company as plan sponsor.

The Commissioners also factored into their deliberations the significant complexity of conducting "at will" litigation over the scope of section 1114 during bankruptcy and the time and expense consumed by such litigation. They evaluated the utility of this litigation to the chapter 11 case. The Commissioners generally found nominal value in the litigation because section 1114 is a process-based provision. Any such changes could occur only if the parties agreed to them through the section 1114 negotiation process or the court authorized the modifications proposed by the debtor in possession after the required negotiations.

Moreover, the Commissioners discussed the purpose and value of the process itself. The steps required by section 1114 provide retirees with representation and a seat at the negotiation table during the chapter 11 case. The process not only gives retirees a voice, but it also ensures that any changes proposed or made by the debtor in possession to retiree benefits are not precipitous and are understood by all affected parties. The Commissioners found value in the process for both the debtor in possession and retirees in cases in which the debtor in possession believed some change to retiree benefits was necessary — regardless of whether the debtor could implement such change unilaterally outside of bankruptcy.

In light of the various relevant factors, the Commission determined that requiring a debtor in possession to follow the section 1114 process for any proposed change to, or termination of, any retiree benefits was the better approach. In reaching this conclusion, however, the Commission also agreed that the debtor in possession's initiation of the section 1114 process where the debtor could have asserted a unilateral right to modify or terminate outside of bankruptcy should not create new claims or otherwise change the claims currently provided under the statute. Accordingly, if the parties agreed to, or the court approved, a change to, or termination of, retiree benefits through the section 1114 process, a debtor in possession asserting an "at will" or other defense limiting its obligations under the prepetition plan could assert such defense in objecting to the amount of any claims asserted by the retirees or their authorized representative arising from the termination or modification of the benefit plan through the section 1114 process. Likewise, the respective rights and remedies of the reorganized debtor and retirees under the prepetition plan (unless such obligations were altered by agreement as part of the 1114 negotiation process) would continue following the debtor's emergence from chapter 11.

E. Administrative Claims

1. Section 503(b)(9) and Reclamation

Recommended Principles:

- The protections afforded by section 503(b)(9) of the Bankruptcy Code should be limited to the value of goods received by, or at the direction of, the debtor in the ordinary course of business within 20 days before the commencement of the case. Section 503(b)(9) should be amended accordingly to permit creditors providing goods on a drop shipment basis to assert appropriate claims under this section.
- A creditor should be required to file a proof of claim and appropriate supporting documentation for any claims it may hold against the estate under section 503(b)(9) on or before the applicable bar date unless otherwise provided by an order of the court. Any such proof of claim should specifically identify the amount of the claim that the creditor asserts is subject to section 503(b)(9). A creditor's failure to file a timely proof of claim should constitute a waiver of such claim unless otherwise provided by an order of the court.
- A party's rights under section 503(b)(9) should replace any rights or remedies that the party may have under applicable nonbankruptcy law based upon reclamation or similar doctrines. Accordingly, section 546(c) should be amended accordingly.

Section 503(b)(9) and Reclamation: Background

Section 503(b)(9) of the Bankruptcy Code provides administrative claim treatment to trade creditors for “the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of business.”⁶³³ The BAPCPA Amendments added this section to the Bankruptcy Code. “The legislative history surrounding this section is scant, but presumably Congress was concerned about providing a vehicle to enhance payment to creditors who shipped goods to a debtor in the ordinary course of business on the eve of bankruptcy.”⁶³⁴

Under section 503(b)(9), trade creditors selling goods (but not providing services) to the debtor during the immediate prepetition period receive an administrative priority claim for the value of those goods that remains unpaid on the petition date, regardless of whether the seller satisfies the requirements for reclamation. Prior to the BAPCPA Amendments, the entirety of a trade creditor's claims were treated as general unsecured claims, unless such creditor could establish a valid reclamation claim under Section 2-702 of the Uniform Commercial Code and section 546 of the

⁶³³ 11 U.S.C. § 503(b)(9).

⁶³⁴ Judith Greenstone Miller & Jay L. Welford, *503(b)(9) Claimants — The New Constituent, a/k/a “The 500 Pound Gorilla,” At The Table*, 5 Depaul Bus. & Com. 487 (2007).

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Bankruptcy Code. To establish a reclamation claim, a creditor was required to, among other things, send its reclamation demand within 10 days after the buyer received the goods.

The BAPCPA Amendments implemented two key changes. First, they elevated certain of a trade creditor's claims to administrative priority under section 503(b)(9). Second, they extended the reclamation reachback period to 45 days and, if the 45-day period had not expired when the bankruptcy petition was filed, granted the creditor an additional 20 days from the commencement of the bankruptcy case to send its written reclamation demand. Although the second change appeared favorable to trade creditors in theory, it has turned out, in practice, to be often illusory. Section 546(c) also states that reclamation rights are expressly subject to the prior rights of a creditor with a security interest in the goods, largely reaffirming prior case law.⁶³⁵

Accordingly, as a practical matter, trade creditors seek to protect a portion of their prepetition claims under section 503(b)(9) and rarely pursue their reclamation rights under state law and section 546(c). One issue that frequently arises in this context is the process trade creditors must follow to preserve their administrative claim under section 503(b)(9). Section 503(b) states that allowance of a claim under that section is subject to notice and a hearing. This may require a creditor asserting a section 503(b)(9) claim to retain counsel and to file a motion because there is no Bankruptcy Code provision or Bankruptcy Rule permitting creditors to assert their section 503(b)(9) claims by filing a proof of claim. In certain cases, in order to simplify the process of asserting section 503(b)(9) claims and to minimize the costs of addressing those claims, debtors have moved for approval of, and courts have approved, procedures that have either authorized the modification of the official proof of claim form (the “**Official Form**”) to include a specific reference to section 503(b)(9) claims or authorized the filing of a separate proof of claim to assert the section 503(b)(9) claim.

Although section 503(b)(9) has provided additional protections to trade creditors who supply goods to the debtor, certain aspects of section 503(b)(9) are ambiguous. The ambiguities include: (i) what constitutes “goods,”⁶³⁶ (ii) how is the “value” of goods determined,⁶³⁷ (iii) when goods have been “received,”⁶³⁸ (iv) whether section 503(b)(9) claims should be disallowed or be subject to setoff when a preference or other claim is asserted against the subject creditor,⁶³⁹ and (v) when should section

635 See, e.g., *In re Furrs Supermarkets, Inc.*, 2012 WL 3396146, at * 3 (Bankr. D.N.M. 2012); *In re Circuit City Stores, Inc.*, 441 B.R. 496, 508–10 (Bankr. E.D. Va. 2010); *In re Advanced Marketing Servs., Inc.*, 360 B.R. 421, 427 (Bankr. D. Del. 2007); *In re Dana Corp.*, 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007).

636 *In re NE Opco, Inc.*, 2013 WL 5880660 (Bankr. D. Del. Nov. 1, 2013) (holding that electricity provided by municipal lighting plant was a service not a good, but natural gas provided by the same plant was a good); *In re S. Mont. Elec. Generation & Transmission Coop., Inc.*, 2013 WL 85162 (Bankr. D. Mont. Jan. 8, 2013) (holding that electricity was a good where debtor was not an end user, but only a wholesaler of electricity); *GFI Wis., Inc. v. Reedsburg Util. Comm'n*, 440 B.R. 791 (W.D. Wis. 2010) (holding that electricity is a good where debtor was not an end user of electricity); *In re Erving Indus., Inc.*, 432 B.R. 354 (Bankr. D. Mass. 2010) (holding that electricity is a good, not a service); *In re Plastech Engineered Prods., Inc.*, 397 B.R. 828 (Bankr. E.D. Mich. 2008) (natural gas is a good). *But cf. In re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that natural gas and water are goods subject to section 503(b)(9), but where debtor is the end user of electricity, electricity is not a good but rather a service, and thus is not subject to section 503(b)(9)); *In re Samaritan Alliance, LLC*, 2008 WL 2520107 (Bankr. E.D. Ky. June 20, 2008) (holding that electricity is better characterized as a service, not a good).

637 *In re S. Mont. Elec. Generation & Transmission Coop., Inc.*, 2013 WL 85162 (Bankr. D. Mont. 2013) (holding that invoice price is proper value of goods); *In re SemCrude, L.P.*, 416 B.R. 399 (Bankr. D. Del. 2009) (same); *In re Pilgrim's Pride Corp.*, 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that replacement cost is the proper value of goods).

638 *In re Momenta, Inc.*, 455 B.R. 353 (Bankr. D.N.H. 2011) (addressing whether drop shipped goods were received by the debtor); *In re Circuit City Stores, Inc.*, 432 B.R. 225 (Bankr. E.D. Va. 2010) (addressing when consigned goods were received by the debtor); *In re Plastech Engineered Prods., Inc.*, 397 B.R. 828 (Bankr. E.D. Mich. 2008) (addressing whether drop shipped good were received by the debtor).

639 *In re Ames Dep't Stores, Inc.*, 582 F.3d 422 (2d Cir. 2009) (holding that section 502(d) is not a ground for disallowance of an administrative priority claim); *In re Energy Conversion Devices, Inc.*, 486 B.R. 872 (Bankr. E.D. Mich. 2013) (same); *In re Plastech Engineered Prods., Inc.*, 394 B.R. 147 (Bankr. E.D. Mich. 2008) (same). See also *In re Momenta, Inc.*, 455 B.R. 353 (Bankr. D.N.H. 2011) (holding that section 502(d) is not a ground for disallowance of a section 503(b)(9) claim); *In re TI*

503(b)(9) claims be paid (on the effective date or sometime earlier).⁶⁴⁰ Both creditors and the estate are affected by these issues and frequently incur litigation costs to try to resolve the uncertainty.

Section 503(b)(9) and Reclamation: Recommendations and Findings

The Commission received conflicting testimony concerning the administrative priority of trade claims for certain goods under section 503(b)(9). Some witnesses testified that this additional class of administrative claims made it more difficult for debtors to reorganize because the chapter 11 plan must pay these claim in full on the effective date under section 1129(a)(9).⁶⁴¹ This testimony was consistent with testimony provided to Congress on the topic of the *Circuit City* bankruptcy and similar retail chapter 11 cases.⁶⁴² Other witnesses strongly disputed that trade claims were an impediment to confirmable plans of reorganization.⁶⁴³

The Commissioners weighed this testimony with anecdotal evidence concerning the types of challenges faced by chapter 11 debtors, including retail debtors, since 2005.⁶⁴⁴ For example, debtors are more highly leveraged.⁶⁴⁵ As a result, they have less value available to support their reorganization efforts. The economic recession that started in 2008 affected several industries and accelerated or contributed to firms' financial distress. The BAPCPA Amendments also made other changes to the Bankruptcy Code that arguably altered chapter 11 practice, at least as compared to the pre-2005 period.⁶⁴⁶

Acquisition, LLC, 410 B.R. 742, (Bankr. N.D. Ga. 2009) (same). *But cf. In re MicroAge, Inc.*, 291 B.R. 503 (B.A.P. 9th Cir. 2002) (holding that debtor could assert preference claim as basis for temporarily disallowing section 503(b)(9) priority claims); *In re Circuit City Stores, Inc.*, 426 B.R. 560 (Bankr. E.D. Va. 2010) (same).

640 *In re Arts Dairy, LLC*, 414 B.R. 219 (Bankr. N.D. Ohio 2009) (explaining that a debtor was not immediately required to pay a section 503(b)(9) claim); *In re Global Home Prods., LLC*, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006) (holding that section 503(b)(9) claim should be paid after confirmation of plan); *In re Bookbinders' Rest., Inc.*, 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006) (holding that claimant was not entitled to immediate payment of section 503(b)(9) claim).

641 *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that section 503(b)(9) puts huge demands on the cash of the debtor and undermines the debtor's reorganization), available at Commission website, *supra* note 55; *Written Statement of Dan Dooley, CEO of MorrisAnderson: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (stating that section 503(b)(9) increases the cost of reorganization which in turn fuels trend toward bankruptcy alternatives), available at Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 10 (Nov. 15, 2012) ("Because holders of administrative claims are not placed in classes and do not vote on a plan, and each administrative creditor must be paid in full in cash at the time of confirmation, unless that creditor agrees otherwise, §503(b)(9) creates holdout power in all members of a particular group of creditors, contrary to the policy of bankruptcy law to reduce such power. Because of that power, and the requirement to pay all administrative expenses even in sale cases, secured creditors will reserve for such claims, reducing the resources available to distressed debtors for reorganization.") (citations omitted), available at Commission website, *supra* note 55.

642 See *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44 (2009) (statements of Harvey R. Miller and Richard M. Pachulski). *But see id.* (statement of Professor Todd J. Zywicki, George Mason School of Law) [hereinafter *Zywicki Statement*]; *Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 21 (2008) (statement of Professor Barry E. Adler, Esq., New York University School of Law) [hereinafter *Adler Statement*].

643 See generally *Transcript, NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013), available at Commission website, *supra* note 55.

644 See, e.g., Bob Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*, J. of Corp. Renewal (Jan. 8, 2009); *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) (stating that BAPCPA deadlines are hurting retail debtors' chances of rehabilitation), available at Commission website, *supra* note 55.

645 See *U.S. Retail Case Studies in Bankruptcy Enterprise Values and Creditor Recoveries*, Fitch Case Studies — Retail Edition 1–2 (Apr. 16, 2013) [hereinafter *Fitch Report*] (observing that there is a "tendency of distressed retailers to maximize secured borrowings, subordination of significant administrative claims and dilution of recoveries from pension, general unsecured trade and operating lease rejection claims placed downward pressure on unsecured recoveries") Analyzing a sample of 20 retail cases, the Fitch Report observed that in each case at least one first lien claim was paid in full, but, alternatively, the median unsecured claim recovery was less than 10 percent, while the average was 20 percent. *Id.* See also Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept./Oct. 2009.

646 See Section III.A, *Brief History of U.S. Business Reorganization Laws*.

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The Commissioners acknowledged that trade creditors are aware of, and rely on, their rights under section 503(b)(9) in making prepetition credit and shipment decisions. Some of the Commissioners raised concerns about the increasing number of administrative and priority claims categories.⁶⁴⁷ Each additional administrative or priority claim category undercuts the Bankruptcy Code's policy of fair and *pro rata* distributions among similarly situated creditors. The Commission agreed that administrative and priority status should be a limited exception and that general unsecured status should be the rule. Several Commissioners did not believe, however, that eliminating the section 503(b)(9) category would provide significant benefits to the estate, but they did believe that it may make operating the debtor's prepetition business more challenging or expensive to the extent that trade creditors refuse to ship goods or will do so only on modified credit or all-cash terms. On balance, the Commission voted to retain the section 503(b)(9) administrative claims priority, provided that this provision represent the only priority treatment made available to such creditors. The Commission also agreed to recommend the elimination of all reclamation rights in bankruptcy under section 546(c), as well as any doctrine of necessity arguments related to these claims.⁶⁴⁸

In making this determination, the Commissioners discussed whether a valid basis existed for excluding drop shipment transactions, when the trade creditor supplies goods on the debtor's behalf to another party, from section 503(b)(9). The Commissioners acknowledged the statutory support for the exclusion given that the debtor does not "receive" the goods in this instance and given that section 503(b)(9) was intended to benefit creditors with reclamation rights.⁶⁴⁹ Nevertheless, they discussed the substance of drop shipment transactions and their use to increase efficiencies in the transactions, which may still be provided for the benefit of the debtor's business. Accordingly, the Commission determined that, if the debtor directed the creditor to ship the goods directly to a third party in lieu of the debtor making that shipment, then applying section 503(b)(9) serves the same policy goal of encouraging trade creditors to supply goods on credit and should apply to the drop shipment transaction.

The Commissioners also discussed the inclusion of services in section 503(b)(9). Again, the Commissioners recognized the difficulty in drawing a bright line to limit the scope of the exception to that necessary to achieve the desired policy goals. They distinguished service providers from suppliers of goods based on their respective state law rights and the use of section 503(b)(9) as a substitution for creditors' state law reclamation rights. They also believed that a debtor in possession would have adequate ability to justify and request authority to pay service providers critical to the business and reorganization efforts through the Commission's proposed codification of the doctrine of necessity, as explained above.⁶⁵⁰

The Commissioners did note the confusion and uncertainty regarding the process for creditors to assert and preserve section 503(b)(9) claims. Some of the Commissioners suggested that, just as with any other administrative claim request, the creditor should be required to file a motion and justify the request. Other Commissioners believed that such a requirement would add unnecessary

647 See, e.g., *Howard Delivery Serv. Inc. v. Zurich Am. Insur. Co.*, 547 U.S. 651, 655 (2006) (explaining that exceptions to general equality principle should be "clearly authorized by Congress" and strictly construed).

648 See Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

649 See, e.g., *Ningbo Chenglu Paper Prods. Mfr. Co., Ltd v. Momena, Inc.* (*In re Momena, Inc.*), 2012 WL 3765171, at *4 (D.N.H. Aug. 29, 2012).

650 See Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

cost to the process and would not be particularly efficient for either the debtor in possession or the estate in many cases. After discussing various alternatives, the Commission agreed that these principles should recommend a modification to section 503(b)(9), the Bankruptcy Rules, and the Official Form to require creditors asserting section 503(b)(9) claims to file a proof of claim for such claims on or before the general bar date or a specific section 503(b)(9) bar date established by the court.

2. Administrative Claims Committee

Recommended Principles:

- Neither the court nor the U.S. Trustee should be authorized to constitute an official committee of administrative claimants. Accordingly, a new provision should be added to section 1102 to clarify this point.

Administrative Claims Committee: Background

Section 1102 of the Bankruptcy Code currently mandates the appointment of a committee of creditors holding unsecured claims and allows the court to order the appointment of other committees of creditors or equity security holders “if necessary to assure adequate representation” of such creditors or equity security holders. In all instances, the members of the committee are vetted and appointed by the U.S. Trustee. As discussed in Section IV.A.4, *Statutory Committees*, committees generally provide a voice for unsecured creditors in the case, protect the rights and interests of unsecured creditors, and serve as a statutory watchdog or check on the debtor in possession.

Traditionally, unsecured creditors were viewed as one of the more vulnerable classes of stakeholders in a chapter 11 case. Many debtors had liquidity or other resources to pay their secured creditors and administrative and priority claimholders, but often did not generate sufficient value to pay unsecured creditors in full, or even a meaningful distribution, in the case. Moreover, the Bankruptcy Code requires a debtor to pay the allowed claims of secured creditors and holders of administrative claims in order to confirm a chapter 11 plan. Accordingly, secured creditors and the holders of administrative claims typically have sufficient protection in a chapter 11 case.

In recent years, the more vulnerable (or perceived vulnerable) classes of stakeholders in a chapter 11 case have moved up in a debtor’s capital structure. The debtor often does not generate sufficient value to pay its administrative claimants. As “administratively insolvent” cases have become more common, some practitioners have questioned whether administrative claimants need representation through the committee structure. Most courts have rejected requests for the appointment of administrative claims committees. The one notable exception is *In re LTV Steel*.

Administrative Claims Committee: Recommendations and Findings

Committees serve oversight and representative functions that generally are lacking in the chapter 11 case. The latter is particularly important in the context of unsecured creditors and, in some cases,

equity security holders whose distributions in the chapter 11 case are determined largely by the value of the estate, or value generated for the benefit of the estate during the case. The Bankruptcy Code does not require a minimum distribution to general unsecured creditors or equity security holders. Rather, plan confirmation standards require only that these parties receive at least as much as they would receive in a chapter 7 liquidation and that, to the extent they are impaired, no junior class receive a distribution.

The Commissioners did not perceive the same risks for administrative claimholders. Although the value generated in a case may prove inadequate and administrative claims may not be satisfied in full, the Bankruptcy Code incorporates protections for these claimholders at least in the confirmation context. In addition, the Commissioners noted that the recommended principles on section 363x sales propose extending similar protection to administrative claimholders in the context of sales of all or substantially all of a debtor's assets. Accordingly, the Commission determined that the additional time and expense often associated with statutory committees were not necessary or warranted with respect to administrative claims.

3. WARN Act Claims

Recommended Principles:

- When a plant closing, mass layoff, or other triggering event under the Worker Adjustment and Retraining Notification Act (the “**WARN Act**”) occurs on or after the filing of the bankruptcy petition, claims for (or on behalf of) employees for damages under the WARN Act should be treated as administrative claims under section 503(b) of the Bankruptcy Code for the number of postpetition days comprising the violation, provided that the claims are otherwise entitled to protection under the WARN Act.

WARN Act Claims: Background

The Worker Adjustment and Retraining Notification Act (the “**WARN Act**”)⁶⁵¹ requires covered employers to provide affected employees with at least 60 days’ advance notice prior to effecting a plant closing or covered mass layoff. The WARN Act is intended to “provide[] protections to workers, their families and communities by requiring employers to provide notification 60 calendar days in advance of plant closings and mass layoffs. Advance notice provides workers and their families some transition time to adjust to the prospective loss of employment, to seek and obtain alternative jobs and, if necessary, to enter skill training or retraining that will allow these workers to successfully

⁶⁵¹ 29 U.S.C. §§ 2101–2109.

compete in the job market.”⁶⁵² When the required notice is not given, employers may be liable for back pay and benefits for the period of the violation, up to a maximum of 60 days.⁶⁵³

There are statutory exceptions that, if established by the employer, would permit a notification period of fewer than 60 days. Under the “faltering company” exception, a company may provide fewer than 60 days’ notice of a plant closing if, during the 60 days prior to shutdown, the company was “actively seeking capital or business, which, if obtained, would have enabled the employer to avoid or postpone the shutdown and the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business.”⁶⁵⁴ In addition, when a mass layoff or plant closing is caused by business circumstances that were “not reasonably foreseeable as of the time the notice would have been required,” the notification period may be reduced.⁶⁵⁵ Similarly, a natural disaster may reduce the notice period.⁶⁵⁶ An employer relying one of the statutory bases for a reduction in the notice period must still provide “as much notice as is practicable.”⁶⁵⁷ Other defenses to WARN Act liability may apply as well.⁶⁵⁸

Employees aggrieved by a violation of the notice requirement, or their representatives,⁶⁵⁹ may assert claims for back pay for “each day of the violation,” and for benefits under an employee benefit plan.⁶⁶⁰ Liability is calculated for the period of the violation, up to a maximum of 60 days. Certain reductions may apply, for example, for any wages paid by the employer for the period of the violation.⁶⁶¹

Liability for WARN Act damages when the requisite notice was not given has been analogized to liability for severance pay in lieu of notice, when courts have viewed such pay to be earned in full upon the triggering event. Thus, courts have held that WARN Act damages give rise to a right to payment upon the occurrence of the event triggering the violation (*i.e.*, the employment termination or mass layoff). Accordingly, the timing of the triggering event generally has determined the payment classification of the claim for bankruptcy purposes. When employment loss occurred prepetition, due to a plant closing or mass layoff that is covered by the WARN Act, the WARN Act damages claim generally has been held to arise in full prepetition, even if the termination occurred close in time to a bankruptcy filing such that a portion of the 60-day period covered by the notice requirement

652 20 C.F.R. § 639.1(a). See *In re FF Acquisition Corp.*, 438 B.R. 886, 891 (Bankr. N.D. Miss. Oct. 26, 2010), *aff’d and appeal dismissed sub nom.* *Angles v. Flexible Flyer Liquidating Trust*, 471 B.R. 182 (N.D. Miss. 2012), *aff’d sub nom.* *In re Flexible Flyer Liquidating Trust*, 511 Fed. App’x 369 (5th Cir. 2013). See also *Hotel Employees & Rest. Employees Int’l Union Local 54 v. Elsinore Shore Assocs.*, 173 F.3d 175, 182 (3d Cir. 1999) (noting adoption of WARN Act “in response to the extensive worker dislocation that occurred in the 1970s and 1980s”).

653 *In re FF Acquisition Corp.*, 438 B.R. 886, 891 (Bankr. N.D. Miss. Oct. 26, 2010), *aff’d and appeal dismissed sub nom.* *Angles v. Flexible Flyer Liquidating Trust*, 471 B.R. 182 (N.D. Miss. 2012), *aff’d sub nom.* *In re Flexible Flyer Liquidating Trust*, 511 Fed. App’x 369 (5th Cir. 2013). See also 29 U.S.C. § 104(a)(1)(A)–(B).

654 29 U.S.C. § 2102(b)(1). See 20 C.F.R. § 639.9(a) (setting forth qualifying requirements for “faltering business” exception).

655 29 U.S.C. § 2102(b)(2). See 20 C.F.R. § 639.9(b)(2) (setting forth indicators where business circumstance may not be reasonably foreseeable).

656 See 29 U.S.C. § 2102(b)(2)(B); 20 C.F.R. § 639.9(c).

657 29 U.S.C. § 2102(b)(3).

658 *E.g., id.* § 2104(a)(4) (providing that, in an action to recover damages, where an employer proves “reasonable grounds for believing that the act or omission was not a violation” of the statute, court may reduce the amount of the liability). See also *id.* § 2103 (listing exemptions where plant closing or mass layoff constitutes a strike or lockout, or closing relates to a temporary facility).

659 See *United Food & Commercial Workers Local 751 v. Brown Grp., Inc.*, 517 U.S. 544 (1996) (holding that union representing affected employees has standing under WARN Act to sue for damages on their behalf).

660 See 29 U.S.C. § 2104(a)(1)(A)–(B).

661 See *id.* § 2104(a)(1), (2).

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included time following the petition date.⁶⁶² When applicable, prepetition WARN Act claims have been held to be subject to the wage priority.⁶⁶³

When the event triggering WARN Act liability occurs postpetition, courts have held that employees terminated postpetition have claims that accrue in full postpetition.⁶⁶⁴ Thus, these cases hold that WARN Act claims based on a postpetition termination are entitled to administrative priority.⁶⁶⁵

One case held differently, although in the context of deciding whether a WARN Act claim should proceed as an adversary proceeding or through the claims adjudication process. In *In re Circuit City*, the plaintiff was terminated postpetition, but the date on which notice should have been given, had his employer complied with the WARN Act, was eight days prior to the petition date.⁶⁶⁶ The debtor argued that the claim arose on the date that notice was due, not on the date of termination. The court's rationale was that, as of the date the company gave notice of the store closing, which occurred prior to the bankruptcy, the employees had a "contingent" claim against the debtor, in the event the debtor's notice was inadequate under the WARN Act.⁶⁶⁷ Thus, the court concluded that (at least for purposes of determining the mechanism for pursuing the claim) the claim arose on the date notice was due. The court thus concluded that the claim should proceed through the claims adjudication process and dismissed the plaintiff's adversary proceeding.

WARN Act Claims: Recommendations and Findings

In considering cases involving postpetition closures or other triggering events under the WARN Act, the Commission agreed that the event giving rise to WARN Act damages is the loss of employment due to the WARN Act triggering event, and not the date the notice should have been given. In order

662 See, e.g., *In re Powermate Holding Corp.*, 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); *Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc.* (*In re Kitty Hawk, Inc.*), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000) (Bankr. N.D. Tex. 2000). See also *In re First Magnus Fin. Corp.*, 403 B.R. 659, 665–66 (D. Ariz. 2009) (holding that WARN Act rights of workers discharged without requisite notice accrue in their entirety upon termination and damages are vested prepetition); *In re Continentalafa Dispensing Co.*, 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) ("Here, Plaintiff was terminated before Debtors filed their petitions and therefore, Plaintiff performed no work after the petitions were filed. Thus, Plaintiff has a prepetition claim.").

663 E.g., *In re Powermate Holding Corp.*, 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); *Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc.* (*In re Kitty Hawk, Inc.*), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000). Courts generally have held that WARN Act damages are considered "wages." E.g., *In re Powermate Holding Corp.*, 394 B.R. 765, 771 (Bankr. D. Del. 2008); *In re Hanlin Grp., Inc.*, 176 B.R. 329, 333 (Bankr. D.N.J. 1995); *In re Riker Indus., Inc.*, 151 B.R. 823 (Bankr. N.D. Ohio 1993); *In re Cargo, Inc.*, 138 B.R. 923, 927 (Bankr. N.D. Iowa 1992).

664 Courts have considered whether to apportion WARN Act damages between prepetition and postpetition periods under section 503(b)(1)(a)(A)(ii), a section added to the Bankruptcy Code pursuant to BAPCPA. However, although courts have consistently declined to apply revised section 503(b) where a WARN Act event occurs prepetition, they have not agreed on an interpretation of this provision that would encompass WARN Act damages. Compare *In re First Magnus Fin. Corp.*, 390 B.R. 667, 679 (Bankr. D. Ariz. 2008) (interpreting section 503(b)(1)(a)(A)(i) and (ii) such that both subparts must apply for subpart (ii) to apply at all, so that statute is inapplicable where no services are rendered postpetition) with *In re Continentalafa Dispensing Co.*, 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) (holding that BAPCPA was not meant to "slant" the law to cover prepetition terminations); *In re Powermate Holding Corp.*, 394 B.R. 765, 777 (Bankr. D. Del. 2008) (holding that statutory use of "and" meant that subparts (i) and (ii) were independent examples of administrative claims, but BAPCPA was not meant to "drastically change the outcome of prepetition employment terminations"). But see *In re Phila. Newspapers, LLC*, 433 B.R. 164, 174–75 (Bankr. E.D. Pa. 2010) (disagreeing with *Powermate's* conclusion that statute must be applied based on the timing of accrual or vesting of right to payment, but holding that statute is inapplicable to back pay award based upon contractual violation). The Commission did not address whether an employment loss resulting from a prepetition WARN Act triggering event could nonetheless fall within BAPCPA.

665 E.g., *In re Beverage Enters., Inc.*, 225 B.R. 111, 115–16 (Bankr. E.D. Pa. 1998) (holding that WARN Act claims of workers who were terminated approximately four months after chapter 11 petition was filed were deemed "severance" benefits that was earned immediately upon termination, that it was indisputable that termination occurred postpetition, and that WARN Act claims were therefore entitled to administrative priority); *In re Hanlin Grp., Inc.*, 176 B.R. 329, 334 (Bankr. D.N.J. 1995) ("Back pay under WARN [Act] is deemed to be earned at the date of termination. Because the date of termination occurred postpetition, any back pay due for a WARN [Act] violation will be deemed as earned postpetition, and therefore in the nature of wages for services rendered after the commencement of the case entitled to administrative priority status.").

666 *In re Circuit City Stores, Inc.*, 2010 WL 120014 (Bankr. E.D. Va. Jan. 7, 2010).

667 *Id.* at *4.

to violate the WARN Act, an employer must effect a mass layoff or plant closing that takes place without providing the requisite WARN Act notice. Until such an event occurs, there has been no violation of the WARN Act. Thus, aggrieved employees should have a postpetition administrative claim for WARN Act damages for the number of postpetition days comprising the violation. The principle would apply assuming the claim for WARN Act damages is otherwise determined to be a valid claim under the WARN Act. The Commission did not address the substance of any potential defenses that may be applicable under the WARN Act, and instead proposed its recommendation strictly on the basis that the appropriate forum has otherwise determined that damages were owed.

The Commission considered whether a bright-line rule that postpetition WARN Act violations give rise to administrative claims might create an incentive for companies with plants or operations that are of doubtful viability to close such plants or operations prepetition rather than trying to turn them around postpetition and risk an administrative priority WARN Act claim if the turnaround effort fails. However, strategic decisions based solely on the economics of a potential WARN Act claim seem unlikely, particularly because most courts already determine payment priority status based on the timing of the triggering WARN Act event, and the Commission's clarifying recommendation would not represent a significant change in current law.

4. Severance Benefits

Recommended Principles:

- An employee's claim for postpetition severance benefits should be eligible for treatment as an administrative claim under section 503(b)(1)(A)(i) of the Bankruptcy Code.
- If an employee is terminated postpetition and entitled to severance benefits that are calculated based on length of service, the employee's claim against the estate for severance benefits should be bifurcated between the prepetition and postpetition periods, such that the employee is permitted to assert (i) a prepetition claim for severance benefits based on prepetition service and (ii) a postpetition administrative claim for severance benefits based on postpetition service. Such an employee also should be permitted to assert a priority claim for any qualifying portion of the prepetition severance benefits claim under section 507.

Severance Benefits: Background

Severance benefits generally are described as payments due to an employee as a result of the termination of employment or some other significant adjustment to or change in the employee's employment circumstances.⁶⁶⁸ In a chapter 11 case, a debtor may reduce its workforce because, for example, it is downsizing, restructuring its business operations, or liquidating. Employees impacted

⁶⁶⁸ 5 Collier on Bankruptcy ¶ 507.06[5](b) (16th ed. 2012).

by these decisions may be covered by prepetition severance plans. These plans may be based on (i) a fixed payment at termination in lieu of notice, or (ii) the terminated employee's length of service.⁶⁶⁹

The treatment of employees' severance benefits in the chapter 11 case is important to both the debtor and its employees. The primary issue in this respect is whether the severance benefits are treated as prepetition unsecured claims or postpetition administrative claims. Section 503(b) of the Bankruptcy Code grants administrative priority to the "actual, necessary costs and expenses of preserving the estate."⁶⁷⁰ These claims generally include costs associated with operating the debtor's business and administering the estate during the chapter 11 case. Section 503(b)(1)(A)(i) specifically identifies "wages, salaries, and commissions for services rendered after the commencement of the case" as administrative claims.⁶⁷¹ These claims are entitled to payment priority (*i.e.*, paid before prepetition unsecured claims are paid) and generally must be paid in full under the chapter 11 plan. Accordingly, the characterization of severance benefits can have significant consequences for the debtor and the terminated employees.

Although not specifically referenced in the statute, courts analyze the treatment of severance benefits under section 503(b)(1)(A)(i).⁶⁷² In general, courts tend to treat severance benefits as prepetition or postpetition claims based on the type of severance plan at issue: if it is a lump sum payment plan in lieu of notice, courts treat the benefits as postpetition claims;⁶⁷³ if it is a plan based on length of service, courts generally allocate the benefits between prepetition and postpetition claims according to when the severance benefits were earned.⁶⁷⁴ Notably, the Second Circuit has rejected the allocation of severance benefits — even under plans based on length of service — finding that the purpose of severance benefits is to compensate the employees for termination, which is the event that should determine the treatment of claims in bankruptcy.⁶⁷⁵ Courts in the Second Circuit thus treat all true severance benefits triggered by a postpetition termination as postpetition administrative claims. Moreover, in the context of section 507(a)(4) priority claims, the Fourth Circuit has determined that severance compensation was "earned" upon the employees' termination.⁶⁷⁶

669 See, e.g., *Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (In re Health Maint. Found.)*, 680 F.2d 619, 621 (9th Cir. 1982); Richard F. Broude, *Reorganizations Under Chapter 11 of the Bankruptcy Code* 6-12.3 (Law Journal Press, 2005).

670 11 U.S.C. § 503(b).

671 *Id.* § 503(b)(1)(A)(i).

672 *Id.* Before a debtor can provide or pay any insider of the debtor administrative priority severance pay, the debtor must satisfy the requirements of section 503(c)(2). *Id.* § 503(c). The Commission did not address the payment of severance or other compensation to insiders under section 503(c).

673 5 Collier on Bankruptcy ¶¶ 503.06[7](d), 507.06[5](b) (16th ed. 2012).

674 See, e.g., *Preferred Carrier Svcs. Va., Inc. v. Phones For All, Inc. (In re Phones For All, Inc.)*, 288 F.3d 730 (5th Cir. 2002); *Bachman v. Commercial Fin. Svcs., Inc. (In re Commercial Fin. Svcs., Inc.)*, 246 F.3d 1291, 1294 (10th Cir. 2001); *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (In re Health Maint. Found.)*, 680 F.2d 619, 621 (9th Cir. 1982); *Cramer v. Mammoth Mart, Inc. (In re Mammoth Mart, Inc.)*, 536 F.2d 950 (1st Cir. 1976); *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947); *Rawson Food Svcs., Inc. v. Creditors' Comm. (In re Rawson Food Svcs., Inc.)*, 67 B.R. 351 (Bankr. M.D. Fla. 1986).

675 *Rodman v. Rinier (In re W.T. Grant Co.)*, 620 F.2d 319 (2d Cir. 1980), *superseded by statute* (Bankruptcy Code) *as recognized in In re Hooker Investments, Inc.*, 145 B.R. 138 (Bankr. S.D. New York. 1992); *Straus-Duparquet, Inc. v. Local Union No. 3, Int'l Bhd. of Elec. Workers, AFL-CIO (In re Straus-Duparquet, Inc.)*, 386 F.2d 649, 651 (2d Cir. 1967), *superseded by statute* (Bankruptcy Code) *as recognized in In re Drexel Burnham Lambert Grp., Inc.*, 138 B.R. 687, 711 (Bankr. S.D.N.Y. 1992) See also *Supplee v. Bethlehem Steel Corp. (In re Bethlehem Steel Corp.)*, 479 F.3d 167, 175 (2d Cir. 2007) ("The key inquiry is whether the payment is a new benefit earned at termination or instead an acceleration of benefits [which the employee accrued over time].").

676 *Matson v. Alarcon*, 651 F.3d 404, 409 (4th Cir. 2011). The Fourth Circuit specifically highlighted the difference in language between section 503(b)(1)(A)(i) and section 507(a)(4), noting that the former — dealing with characterization of employee payments as administrative claims — expressly tied such claims to "services rendered after the commencement of the case." *Id.* Accordingly, the Fourth Circuit's decision may have limited application in the analysis of severance benefits arising from a postpetition termination.

Severance Benefits: Recommendations and Findings

The Commission considered two issues with respect to severance benefits in chapter 11: first, whether section 503(b)(1)(A)(i) should be amended to specifically reference severance benefits, in addition to “wages, salaries, and commissions for services rendered after the commencement of the case”; and second, whether the Bankruptcy Code should be amended to address the treatment of severance benefits relating to a postpetition termination or other triggering event. The Commission agreed that “severance benefits” should be added to section 503(b)(1)(A)(i) and largely viewed this change as a technical amendment. The Commissioners engaged in a more in-depth analysis of the treatment of severance benefits as prepetition or postpetition claims.

The Commissioners discussed the underlying nature of severance benefits. Some of the Commissioners viewed severance benefits in all circumstances as compensation for the termination itself, not wages or compensation for services previously rendered. These Commissioners emphasized that severance benefits are intended to mitigate at least some of the hardship imposed upon employees by the termination of employment and the resulting loss of wages and benefits. They also observed that, even if a severance plan uses length of service to calculate the amount of the severance benefit, that reference is solely a calculation tool and does not necessarily speak to the nature or purpose of the benefit. Finally, these Commissioners highlighted the additional burden on more senior employees imposed by an allocation rule. These employees may have the majority of their severance benefits calculated based on a long prepetition tenure with the debtor, arguably penalizing them for their loyalty and service to the debtor.

Other Commissioners strongly believed that severance benefits calculated based on length of service should be deemed earned when such services were provided. This approach requires an allocation of the severance benefits between the prepetition and postpetition periods. These Commissioners observed that many claims are bifurcated in this manner under the Bankruptcy Code, and they did not find justification for varying it in the employment context. They also emphasized that administrative claims must be grounded in value provided to the estate — whether to preserve or enhance the estate — and focused on the general purpose and language of section 503(b) of the Bankruptcy Code.

In vetting these issues, the Commission considered the U.S. Supreme Court’s decision in *United States v. Quality Stores*.⁶⁷⁷ In *Quality Stores*, the Supreme Court held that severance payments were wages for purposes of FICA, and provided guidance on how to characterize these types of payments. Specifically, the Supreme Court explained:

[S]everance payments often vary, as they did here, according to the function and seniority of the particular employee who is terminated. For example, under both termination plans, Quality Stores employees were given severance payments based on job grade and management level. And under the second termination plan, nonofficer employees who had served at least two years with their company received more in severance pay than nonofficer employees who had not — a standard example of a company policy to reward employees for a greater length of good service and loyalty.

⁶⁷⁷ *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014).

In this respect severance payments are like many other benefits employers offer to employees above and beyond salary payments. Like health and retirement benefits, stock options, or merit-based bonuses, a competitive severance payment package can help attract talented employees. Here, the terminations leading to the severance payments were triggered by the employer's involuntary bankruptcy proceeding, a prospect against which employees may wish to protect themselves in an economy that is always subject to changing conditions.⁶⁷⁸

Some of the Commissioners asserted that the Supreme Court's holding in *Quality Stores* suggested that the characterization of severance benefits as payment either due upon termination or for services previously provided by an employee should be left to the courts to resolve on a case-by-case basis. The advisory committee recommended this approach as well. Other Commissioners did not necessarily disagree with this assessment, but argued that the Bankruptcy Code should still clarify the treatment of severance benefits if the court determines they are earned based upon length of service under the applicable severance plan. The Commission recommended that the Bankruptcy Code codify an allocation rule for severance benefits triggered postpetition and calculated based on length of service. For additional views on the recommended principles for severance benefits, see *Appendix G*.

F. General Valuation Standards

Recommended Principles:

- The court should continue to determine valuation issues based on the evidence presented by the parties. The Bankruptcy Code should not dictate the valuation methodology to be used by the court in resolving these issues. Accordingly, no change to existing law is suggested on this point.
- The court should be permitted to use a court-appointed expert and to rely on the hearing testimony of a court-appointed expert in addition to any expert offered by the parties to assist in determining valuation issues. Section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence permit the court to appoint valuation experts. Accordingly, no change to existing law is suggested on this point.

General Valuation Standards: Background

Valuation issues arise at various points in a chapter 11 case. Parties may need a valuation of the debtor's assets early in the case to resolve, for example, a secured creditor's request for adequate protection under section 361 or to assess a proposed sale of some or all of a debtor's assets under section 363. They may need to revisit valuation issues later in the case in connection with creditors'

⁶⁷⁸ *Id.* at 1499.

requests for relief from the automatic stay or confirmation of a chapter 11 plan. Indeed, the value of a debtor's assets impacts adequate protection requests, postpetition financing terms and collateral, the amount of secured creditors' allowed secured claims against the estate, distributions available to creditors in the case, the feasibility of a plan, and the application of the absolute priority rule in the plan cramdown context.⁶⁷⁹ Nevertheless, the Bankruptcy Code does not address valuation issues directly in the chapter 11 context or mandate a particular methodology for valuing a debtor's assets.

Accordingly, courts generally determine the value of a debtor's assets, and resolve any related valuation disputes, based on the evidence presented by the parties at the hearing on the matter. This method, commonly referred to as "judicial valuation," introduces some uncertainty into the process, but it also allows courts to consider various valuation methodologies and to tailor the valuation to the facts and circumstances at hand. Parties may value the debtor's assets based on, among other factors, a balance sheet analysis, a discounted cash flow analysis, or market comparables.⁶⁸⁰ Parties typically introduce this evidence through expert testimony at the hearing, and courts weigh and consider this testimony and the other evidence in reaching their valuations. Empirical studies suggest that courts thoughtfully consider valuation disputes and do not simply resolve such matters by splitting the difference.⁶⁸¹

In addition to relying on the parties' experts, courts also may appoint an expert to testify on valuation issues. Rule 706 of the Federal Rules of Evidence provides that "the court may appoint any expert that the parties agree on and any of its own choosing." In addition, the court may establish the expert's duties and compensation in the order of appointment. Court-appointed experts generally are subject to discovery and cross-examination. Moreover, some courts have invoked section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence to appoint "experts with teeth," in that the court-appointed expert served both as a valuation expert for the court and a mediator between the parties on the valuation issues.⁶⁸²

General Valuation Standards: Recommendations and Findings

In general, valuation is more art than science. Regardless of the valuation methodology, the results depend on a variety of factors, including timing, market conditions, assumptions, and appraisers.⁶⁸³ As one court explained:

⁶⁷⁹ Section 506(a)(1) provides that a secured creditor's claim is secured to the extent of the value of its collateral and that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1). In addition, section 506(a)(2) provides more specific guidance in the case of an individual under chapter 7 or 13. *Id.* § 506(a)(2) (mandating valuation based on the replacement value of the property as of the petition date in individual chapter 7 and 13 cases).

⁶⁸⁰ See Bernard Trujillo, *Patterns in a Complex System: An Empirical Study of Valuation in Business Bankruptcy Cases*, 53 UCLA L. Rev. 356 (2005). In addition, parties may present testimony of a potential purchaser or prospective user of the property at issue; the contract method or rates agreed to by the parties, or general observations about market or industry trends for such property. *Id.* at 383–85.

⁶⁸¹ Compare *id.* at 370 (study of 180 observations drawn from 145 published opinions reported in the Westlaw computer database decided from 1979 through 1998, finding "complete success for the debtor or for the creditor — about equally . . . [C]ourts very rarely split the difference between the debtor's and the creditor's numbers") with Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 Fla. St. U. L. Rev. 387, 396 (2005) (study of 24 valuation disputes, finding "(1) bankruptcy judges on average allocated 65.2% of the value in controversy to debtors and only 34.8% to secured creditors; and (2) bankruptcy judges were more than three times as likely to allocate most of the value in controversy to debtors as they were to secured creditors"). See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

⁶⁸² See, e.g., *In re Calpine Corp.*, 377 B.R. 808 (Bankr. S.D.N.Y. 2007).

⁶⁸³ See, e.g., Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1941–42 (2006) ("A business, however, cannot be valued with such precision. There are different methods of valuing a business, but in the end all are merely estimates of the present value of the business's future earning capacity.").

[T]he valuation of an enterprise . . . is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing. There are too many variables, too many moving pieces in the calculation of value . . . for the court to have great confidence that the result of the process will prove accurate in the future. Moreover, the court is constrained by the need to defer to experts and, in proper circumstances, to Debtors' management.⁶⁸⁴

The Commissioners discussed the uncertainty surrounding valuation generally and considered whether judicial valuation significantly enhanced this uncertainty. Such inherent uncertainty is recognized in the legislative history of the Bankruptcy Code, which explains that, “[a]s Peter Coogan has aptly noted, such a valuation [of the enterprise in connection with applying the absolute priority rule] is usually ‘a guess compounded by an estimate.’”⁶⁸⁵ The Commission reviewed valuation methodologies used as part of, or independent from, judicial valuation to value a debtor’s assets or business as a going concern. These methodologies include discounted cash flow, market comparables, and securities based valuations, among others. The Commissioners explored how different components of these valuation methodologies are subject to varying interpretation or application, which can cause fluctuation in asset or business valuations.⁶⁸⁶ For example, an empirical study of companies emerging from chapter 11 prior to 1994 finds “that estimates of value are generally unbiased, but the estimated values are not very precise — the sample ratio of estimated value to market value varies from below 20 percent to more than 250 percent.”⁶⁸⁷ The authors of this study suggest that the variance in valuations may result from the administrative bankruptcy process or from strategic distortion. “The strategic distortion explanation for the imprecision of the cash flow forecasts implies that the valuation errors are systematically related to proxies for the competing financial interests and relative bargaining strengths of the parties.”⁶⁸⁸

The Commissioners also examined the impact of valuation uncertainty on chapter 11 cases. Many of the Commissioners commented that although valuation litigation can be time-consuming and expensive,⁶⁸⁹ judicial valuation and any related uncertainty can encourage negotiated resolutions.⁶⁹⁰ A negotiated resolution of valuation uncertainty aligns with the consensual nature of the chapter 11 process. Although disputes arise and not every chapter 11 is consensual, commentators typically describe “the goal of a Chapter 11 restructuring [as achieving] a consensual plan of reorganization.”⁶⁹¹ Chapter 11’s preference for consensual resolutions evolved at least in part from business reorganization’s Chapter XI roots. A consensual plan between the debtor and its unsecured creditors was the hallmark of the Chapter XI process under the Bankruptcy Act.⁶⁹²

The Commissioners found continued utility in the judicial valuation approach, including the flexibility it gives the parties in selecting the best valuation methodology. Judicial valuation allows the court and parties to consider market valuations, book and adjusted book valuations, and other

684 *In re Mirant Corp.*, 334 B.R. 800, 848 (Bankr. N.D. Tex. 2005).

685 1977 House Judiciary Committee Report on Public Law 95-598, at 222.

686 See Baird & Bernstein, *supra* note 683, at 1943 (“Differences of 10% are almost inevitable, and often the differences are far larger.”).

687 Stuart C. Gilson et al, *Valuation of Bankrupt Firms*, 13 Rev. Fin. Studies 43–74 (2000) (“This study explores the relation between the market value of 63 publicly traded firms emerging from Chapter 11 and the values implied by the cash flow forecasts in their reorganization plans.”).

688 *Id.*

689 *In re Mirant Corp.*, 334 B.R. 800, 809, 824 (Bankr. N.D. Tex. 2005) (conducting 27-day valuation trial with separate valuation experts for key parties testifying to values ranging from \$7.2 billion to \$13.6 billion).

690 See Baird & Bernstein, *supra* note 683, at 1963 (“These dynamics regularly lead to negotiated reorganization plans with basic features consistent with the idea that valuation uncertainty plays a key role in dictating the contours of such plans.”).

691 Miller & Waisman, *Is Chapter 11 Bankrupt?*, *supra* note 26, at 144–45.

692 For discussion of Chapter XI of the Bankruptcy Act, see Section III.A, *Brief History of U.S. Business Reorganization Laws*.

factors that may be relevant to particular debtor and its reorganization efforts. The Commissioners were also mindful, however, of witness testimony suggesting that judges may need assistance with complex or contested valuations. For example, the Honorable James Peck of the U.S. Bankruptcy Court for the Southern District of New York testified as follows:

An inexperienced judge navigating unfamiliar territory introduces an extra element of risk and uncertainty into what necessarily is an unpredictable process in which the skills and personality of the advocate and witness may be the most important variables. An experienced judge is likely to be more facile in deciding these questions but reliability and predictability remain a problem because the experienced judge will be applying his or her own valuation judgments without being able to confer with someone deeply grounded in the subject. Such a valuation professional would be more skilled than most judges in being able to verify or question the assumptions and adjustments that so often dictate the conclusions reached. Valuation is an art more than a science, and it would be helpful for the Court to have access to a seasoned art critic in deciding whether a particular challenged valuation is genuine or a fake.⁶⁹³

The Commission reviewed witness testimony and related anecdotal evidence on valuation. The Commission agreed that courts should be permitted and encouraged to appoint valuation experts in cases in which such an expert can provide assistance to the court. The Commissioners debated whether an appointed expert should be permitted to consult with, and to advise the court, but not necessarily be called to testify in the case. After debating the benefits to the court and the due process and procedural concerns for the parties, the Commission agreed that, if the court intends to rely on the court-appointed valuation expert, such expert must testify in the case and be subject to cross-examination. The Commissioners also observed that estate neutrals under the recommended principles could now perform the expanded role, including that of mediator, served by court appointed valuation experts in the past. Finally, the Commissioners evaluated the language of Rule 706 of the Federal Rules of Evidence and found it sufficient as written for the contemplated role of court-appointed valuation experts.

G. Standard for Reviewing Settlements and Compromises

Recommended Principles:

- The principles and standards of Bankruptcy Rule 9019 should be codified to foster uniform application of a court's authority to approve a settlement or compromise of controversies in a chapter 11 case. Accordingly, the court, after notice and a hearing, should approve a trustee's proposed settlement or compromise of a controversy only if the court finds, based on the evidence presented, that the proposed settlement or compromise is reasonable and in the best interests of the estate.

⁶⁹³ Written Statement of Honorable James M. Peck, VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2 (Feb. 21, 2013), available at Commission website, *supra* note 55.

Standard for Reviewing Settlements and Compromises: Background

In general, “compromises are favored in bankruptcy.”⁶⁹⁴ Negotiated resolutions of disputes can create efficiencies in the process and cost savings for the parties. Bankruptcy Rule 9019, like its predecessor Rule 919 under the Bankruptcy Act, provides a process for parties to request court approval of settlements and compromises. Specifically, Bankruptcy Rule 9109 states, in relevant part: “On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement.”⁶⁹⁵ Notably, neither the Bankruptcy Rules nor the Bankruptcy Code provide a standard or criteria for the court to use in assessing proposed settlements and compromises.

Given general bankruptcy policy and the lack of guidance in the Bankruptcy Rules and the Bankruptcy Code, courts tend to invoke a “presumption in favor of settlements,” and approve a proposed settlement or compromise unless it “fall[s] below the lowest point in the range of reasonableness.”⁶⁹⁶ Various courts have developed factors to assist in this determination, but not all courts use the same factors or apply the factors in a uniform manner.⁶⁹⁷ This variation can cause uncertainty for the parties filing motions under Bankruptcy Rule 9019 and inconsistent rulings on proposed settlements and compromises. In addition, courts take different approaches to reviewing settlements and compromises incorporated into plans of reorganization.⁶⁹⁸ This latter issue is discussed below.⁶⁹⁹

Standard for Reviewing Settlements and Compromises: Recommendations and Findings

A trustee⁷⁰⁰ may seek to settle any number of disputes in the chapter 11 case, including claims resolution matters, avoidance claims, and prepetition litigation. Because any such settlement necessarily impacts the estate — either because the estate will fund at least a portion of the settlement or the estate’s claims against third parties are being compromised — the court and parties in interest

⁶⁹⁴ *Myers v. Martin (In re Martin)*, 91 F.3d 389, 393 (3d Cir. 1996), quoting 9 Collier on Bankruptcy ¶ 9019.03[1] (15th ed. 1993).

⁶⁹⁵ Fed. R. Bankr. P. 9019(a).

⁶⁹⁶ *In re Tower Auto., Inc.*, 342 B.R. 158, 164 (Bankr. S.D.N.Y. 2006), *aff’d*, 241 F.R.D. 162 (S.D.N.Y. 2006). *See also* *Hicks, Muse & Co., Inc. v. Brandt (In re Healthco Int’l, Inc.)*, 136 F.3d 45, 50 n.5 (1st Cir. 1998) (holding that court may accord deference to the position of the trustee or debtor in possession); *In re WorldCom, Inc.*, 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006) (“While the bankruptcy court may consider the objections lodged by parties in interest, such objections are not controlling . . . the bankruptcy court must still make informed and independent judgment.”); *In re Hibbard Brown & Co., Inc.*, 217 B.R. 41, 46 (Bankr. S.D.N.Y. 1998) (holding that court may exercise its discretion under Bankruptcy Rule 9019 “in light of the general public policy favoring settlements”).

⁶⁹⁷ Courts consider a variety of factors, including:

(1) the balance between the litigation’s possibility of success and the settlement’s future benefits; (2) the likelihood of complex and protracted litigation, with its attendant expense, inconvenience and delay, including the difficulty in collecting on the judgment; (3) the paramount interests of the creditors, including each affected class’s relative benefits and the degree to which creditors either do not object to or affirmatively support the proposed settlement; (4) whether other parties in interest support the settlement; (5) the competency and experience of counsel supporting, and the experience and knowledge of the bankruptcy court judge reviewing, the settlement; (6) the nature and breadth of releases to be obtained by officers and directors; and (7) the extent to which the settlement is the product of arm’s length bargaining.

In re Iridium Operating LLC, 478 F.3d 452, 462 (2d Cir. 2007) (internal citations omitted). Although several of these factors were developed by courts in the plan settlement context, they also apply outside the plan context in certain instances.

⁶⁹⁸ A related but different issue arises when the proposed settlement “has the effect of dictating the terms of a prospective chapter 11 plan.” *In re Capmark Fin. Grp. Inc.*, 438 B.R. 471, 513 (Bankr. D. Del. 2010). In those instances, courts may deny approval of the settlement because it constitutes an impermissible *sub rosa* plan. *See generally*, Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37 (1999).

⁶⁹⁹ *See* Section VI.F.4, *Settlements and Compromises in Plan*.

⁷⁰⁰ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

should have an opportunity to review the terms of the proposed settlement. The settlement or compromise also should be subject to court approval.

The Commissioners discussed the soundness of the notice and hearing process required by Bankruptcy Rule 9019, but acknowledged the discretion given the trustee in presenting the settlement, and the court in approving or denying the settlement. Beyond requiring notice and a hearing, Bankruptcy Rule 9019 establishes no parameters for the content or timing of settlements. It also does not set forth a standard or criteria for the assessment of settlements. The Commission agreed that codifying the settlement approval process, including an appropriate standard of review, would further facilitate the bankruptcy policy of encouraging consensual resolution of disputed matters.

The Commission reviewed the courts' various approaches to assessing proposed settlements and compromises under Bankruptcy Rule 9019. This review identified a wide range of approaches, from "the lowest point of reasonableness" to the "fair and equitable" standard used to evaluate compromises and plans under the Bankruptcy Act. The Commissioners generally agreed that the lowest point of reasonableness standard did not sufficiently scrutinize the terms of the proposed settlement and its impact on the estate. Several Commissioners suggested using the fair and equitable standard as applied by the U.S. Supreme Court in *TMT Trailer Ferry*.⁷⁰¹ Other Commissioners expressed concern regarding the ambiguity surrounding "fair and equitable" and its common association with approval of a chapter 11 plan in the cramdown context.⁷⁰² The Commissioners generally agreed that something less than fair and equitable, but still meaningful, should govern the approval of settlements and compromises.

After discussing different approaches, the Commission agreed to use a hybrid standard that requires the settlement or compromise to be "reasonable and in the best interests of the estate." It favored this standard because it would adequately protect the estate and allow the court to weigh the evidence presented on the particular settlement or compromise. Although the Commission believed that the proposed "reasonable and in the best interests of the estate standard" is better suited than a "fair and equitable" standard for the review and approval of settlements and compromises, it also believed that courts should still engage in a totality of the circumstances analysis that considers factors such as those articulated by courts under the fair and equitable approach.⁷⁰³

⁷⁰¹ Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968).

⁷⁰² The fair and equitable standard is used in the cramdown context under section 1129 of the Bankruptcy Code. The Bankruptcy Code also incorporates elements necessary to make a plan fair and equitable to any particular class of creditors or equity securities holders that reject the plan.

⁷⁰³ See, e.g., Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968) ("[T]he judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.").

H. The *In Pari Delicto* Doctrine

Recommended Principles:

- The *in pari delicto* defense should be inapplicable to claims for relief that a trustee appointed under section 1104 in the chapter 11 case asserts against third parties under section 541 of the Bankruptcy Code. The absence of the *in pari delicto* defense should not otherwise affect the trustee's burden to establish the claims for relief under applicable law.
- The Commission was unable to reach a consensus on eliminating the *in pari delicto* defense with respect to claims for relief that other estate fiduciaries or parties authorized to act on behalf of the estate (e.g., litigation trustees, postconfirmation entities, unsecured creditors' committees, debtors in possession) might assert against third parties under the Bankruptcy Code.

The In Pari Delicto Doctrine: Background

The Latin phrase *in pari delicto* means “in equal fault,”⁷⁰⁴ and the *in pari delicto* doctrine generally bars the pursuit of a cause of action by a plaintiff who allegedly acted in concert with the defendants, or was otherwise involved, in the wrongful conduct underlying the plaintiff's complaint. The *in pari delicto* doctrine is “grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.”⁷⁰⁵ The *in pari delicto* issue arises in a variety of instances in chapter 11 cases, but perhaps most commonly in cases precipitated by a prepetition Ponzi scheme.⁷⁰⁶

In many cases, the underlying cause of action is grounded in prepetition conduct and belongs to the estate under section 541 of the Bankruptcy Code. The target defendant might be an accountant, auditor, attorney, bank, broker, insider, or others. The state law claim might be aiding and abetting fraud, breach of fiduciary duty, negligence, malpractice, aiding and abetting breach of fiduciary duty, negligent misrepresentation, negligent supervision, or conspiracy. Among the defendant's affirmative defenses is *in pari delicto*. Under present law, because the debtor's wrongdoing would bar any recovery by the debtor, the trustee is likewise entitled to no relief. Every circuit except the Ninth Circuit has ruled on the issue and has held that, under section 541, the *in pari delicto* doctrine bars a trustee's claims when the doctrine would bar the claims if brought by the debtor.⁷⁰⁷

⁷⁰⁴ See, e.g., *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 306 (1985).

⁷⁰⁵ *Mosier v. Callister, Nebeker & McCullough PC*, 546 F.3d 1271, 1275 (10th Cir. 2008).

⁷⁰⁶ In the context of reviewing fraudulent transfer law under section 548 of the Bankruptcy Code, the Commission considered codifying the “Ponzi scheme presumption,” which would basically create a rebuttable presumption that transfers made in furtherance of a Ponzi scheme are fraudulent transfers subject to avoidance. See, e.g., *In re Manhattan Inv. Fund Ltd.*, 397 B.R. 1, 11–13 (S.D.N.Y. 2007). The term “Ponzi scheme” is not well defined under the case law. *Id.* After much deliberation, the Commission decided that this issue was best left to further development under the case law.

⁷⁰⁷ See, e.g., *Peterson v. McGladrey & Pullen, LLP (In re Lancelot Investors Fund, L.P.)*, 676 F.3d 594 (7th Cir. 2012); *Gray v. Evercore Restructuring L.L.C.*, 544 F.3d 320, 324–25 (5th Cir. 2008); *Mosier v. Callister, Nebeker & McCullough*, 546 F.3d 1271, 1276 (10th Cir. 2008); *Baena v. KPMG LLP*, 453 F.3d 1, 6 (1st Cir. 2006); *Nisselson v. Lernout*, 469 F.3d 143, 153 (1st Cir. 2006), *cert. denied*, 550 U.S. 918 (2007); *Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards*, 437 F.3d 1145, 1149–56 (11th Cir. 2007).

Courts have recognized certain exceptions to the application of the *in pari delicto* doctrine. For example, the “adverse interest” exception provides that if the officers and directors of the debtor who participated in the fraudulent transactions were acting in their own interests and to the detriment of the debtor, then the adverse interest exception defeats the *in pari delicto* doctrine.⁷⁰⁸ Another exception, known as the “innocent decision maker” exception, may apply if not all of the “shareholders or decision makers are involved in the fraud” — *i.e.*, there was at least one innocent insider to whom the defendant could have reported their findings.⁷⁰⁹ Some courts have found the innocent decision maker exception inapplicable, however, when an innocent member of management “could and would have prevented the fraud had they been aware of it.”⁷¹⁰

In addition, the *in pari delicto* doctrine applies only to a trustee’s claims under section 541. Accordingly, courts have determined that the doctrine should not apply to, for example, the trustee’s “strong arm” claims under section 544;⁷¹¹ preference claims under section 547;⁷¹² and fraudulent transfer claims under section 548.⁷¹³

Despite the various exceptions, the *in pari delicto* doctrine may preclude the trustee from pursuing causes of action that benefit the estate and the beneficiaries of the estate who are innocent victims as to the underlying cause of action. Several commentators thus have questioned the relevance and fairness of applying the *in pari delicto* doctrine in bankruptcy cases. These commentators note, among other things, that state and federal law receivers generally are not subject to the *in pari delicto* defense.⁷¹⁴ The question persists whether trustees in bankruptcy should have the same ability to pursue actions against third parties to the same extent as a state law receiver (or a receiver under the Federal Depositary Insurance Act or the federal securities laws), or whether trustees should be treated differently, given the bankruptcy maxim that a trustee stands in the shoes of the debtor and is subject to the same defenses as the debtor.⁷¹⁵

2006), *cert. denied*, 549 U.S. 811 (2006); Grassmuck v. Am. Shorthorn Ass’n, 402 F.3d 833, 836–37 (8th Cir. 2005); Logan v. JKV Real Estate Servs. (*In re Bogdan*), 414 F.3d 507, 514–15 (4th Cir. 2005), *cert. denied*, 546 U.S. 1093 (2006) (noting exception where claims have been assigned to trustee); Official Comm. of Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 354–60 (3d Cir. 2001); Terlecky v. Hurd (*In re Dublin Sec., Inc.*), 133 F.3d 377, 380 (6th Cir. 1997), *cert. denied*, 525 U.S. 812 (1998); Sender v. Buchanan (*In re Hedged-Invs. Assocs., Inc.*), 84 F.3d 1281, 1284–86 (10th Cir. 1996); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118–20 (2d Cir. 1991). *But see* USACM Liquidating Trust v. Deloitte & Touche, 754 F.3d 645, 649 (9th Cir. 2014), *aff’g* 764 F. Supp. 2d 1210, 1229 (D. Nev. 2011). Notably, the Second Circuit appears to treat the issue not as a defense like the other circuits, but as an issue of standing. *See* Breeden v. Kirkpatrick & Lockhart LLP (*In re Bennett Funding Grp., Inc.*), 336 F.3d 94, 100 (2d Cir. 2003); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991).

708 Bankruptcy Servs., Inc. v. Ernst & Young (*In re CBI Holding Co., Inc.*), 529 F.3d 432 (2d Cir. 2008). Importantly, there are variations on the adverse interest exception. For example, some courts narrowly interpret the exception to apply when the guilty manager has “totally abandoned” the interest of the principal corporation, while other courts engage in an analysis of the respective benefits received by the corporate entity and the wrongdoer insider, *Thabault v. Chait*, 541 F.3d 512, 527 (3d Cir. 2008); *Baena v. KPMG, LLP*, 453 F.3d 1, 8 (1st Cir. 2006); *Breeden v. Kirkpatrick & Lockhart LLP* (*In re Bennett Funding Grp.*), 336 F.3d 94, 100 (2d Cir. 2003). Other courts have found that the adverse interest exception should be determined by the agent’s subjective motives, rather than by a strict rule of whether the debtor received any benefit as a result of the agent’s activities, *Bankruptcy Servs. Inc. v. Ernst & Young* (*In re CBI Holding Co., Inc.*), 529 F.3d 432, 451 (2d Cir. 2008).

709 *Smith v. Andersen L.L.P.*, 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); *Breeden v. Kirkpatrick & Lockhart, LLP*, 268 B.R. 704, 710 (S.D.N.Y. 2001), *aff’d*, *In re Bennett Funding Group, Inc.*, 336 F.3d 94 (2d Cir. 2003); *SIPC v. BDO Seidman, LLP*, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999), *aff’d in part*, 222 F.3d 63 (2d Cir. 2000).

710 *See, e.g., In re CBI Holding Co., Inc.*, 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff’d in part, rev’d in part*, 529 F.3d 432 (2d Cir. 2008).

711 *Kaliner v. MDC Sys. Corp., LLC*, 2011 U.S. Dist. LEXIS 5377, at *15 (E.D. Pa. Jan. 20, 2011).

712 *See, e.g., In re CBI Holding, Inc.*, 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff’d in part, rev’d in part*, 529 F.3d 432 (2d Cir. 2008).

713 *McNamara v. PFS* (*In re Pers. & Bus. Ins. Agency*), 334 F.3d 239, 245–47 (3d Cir. 2003).

714 *See* FDIC v. O’Melveny & Myers, 61 F.3d 17, 18–19 (9th Cir. 1995); *Scholes v. Lehmann*, 56 F.3d 750, 754–55 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995); *Goldberg v. Chong*, 2007 U.S. Dist. LEXIS 49980, *28–29 (S.D. Fla. July 11, 2007).

715 Some courts follow the bankruptcy analogy and conclude that because the receiver simply steps into the shoes of the receivership entity in pursuing the entity’s claims, and because the *in pari delicto* doctrine would bar the entity’s claim, it bars the receiver’s claim. *See, e.g., Wuliger v. Mfrs. Life Ins. Co.*, 567 F.3d 787, 792 (6th Cir. 2009); *Knauer v. Jonathon Roberts Fin. Grp., Inc.*,

The In Pari Delicto Doctrine: Recommendations and Findings

The *in pari delicto* doctrine's application to certain of a trustee's or other estate representative's claims against third parties in a bankruptcy case is subject to much debate in the literature. The conclusion that parties cannot assert the *in pari delicto* defense against claims that are available only to the trustee in a bankruptcy case — such as preference claims and fraudulent conveyance claims — is well supported. A debtor has no rights in, or ability to pursue, such claims, and the trustee does not stand in the shoes of the debtor for purposes of those actions. Prepetition claims of the debtor that become property of the estate under section 541 of the Bankruptcy Code may, however, require a different analysis. The Commission considered current trends in the case law on the *in pari delicto* doctrine, the underlying justifications for the doctrine, and whether a trustee or estate representative *should* be subject to the *in pari delicto* defense in bankruptcy, irrespective of the genesis of the claims.

The Commission reviewed the primary purposes of the *in pari delicto* doctrine, most commonly articulated as follows: that “courts should not lend their good offices to mediating disputes among wrongdoers” and “denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.”⁷¹⁶ The Commissioners generally agreed that the doctrine served these basic goals when applied outside of bankruptcy: a company that participated in a wrong should not be able to benefit from that wrong. For some of the Commissioners, however, the intervention of a bankruptcy case changed the calculus dramatically.

In bankruptcy, a party not involved with the alleged prepetition wrongdoing may bring the action for the benefit of the estate (e.g., innocent creditors of the debtor). That party typically is the trustee, unsecured creditors' committee, litigation trustee, or other estate representative. The trustee, unsecured creditors' committee, litigation trustee, or other estate representative did not participate in the wrong and is not seeking recoveries that would benefit any of the wrongdoers. Indeed, to the extent that the debtor's prepetition shareholders, officers, or directors who may have been involved with the alleged wrongdoing are creditors of the estate, those claimants can be barred from receiving any recoveries from the litigation.

Several of the Commissioners found the case for not allowing third parties to assert the *in pari delicto* defense against the trustee or other estate representative very compelling. These Commissioners

348 F.3d 230, 236 (7th Cir. 2003); *In re Wiand*, 2007 WL 963165, at *6–7 (M.D. Fla. Mar. 27, 2007). Other courts conclude that because the receiver's role is to protect innocent investors, and because these investors were not complicit in the fraud, the *in pari delicto* doctrine does not bar the receiver's claim. See, e.g., *Jones v. Wells Fargo Bank, N.A.*, 666 F.3d 955, 966 (5th Cir. 2012) (“A receiver is ‘the representative and protector of the interests of all persons, including creditors, shareholders and others, in the property of the receivership.’ . . . The receiver has a duty to pursue a corporation's claims.” . . . Although a receiver generally ‘has no greater powers than the corporation had as of the date of the receivership,’ it is well established that ‘when the receiver acts to protect innocent creditors . . . he can maintain and defend actions done in fraud of creditors even though the corporation would not be permitted to do so.’ . . . The receiver thus acts on behalf of the corporation as a whole, an entity separate from its individual bad actors.”) (citations omitted); *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995) (“A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects. This places the receiver in stark contrast to the normal successor in interest who voluntarily purchases a bank or its assets and can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses. In such cases, the bank receives less consideration for its assets because of its inequitable conduct, thus bearing the cost of its own wrong.”); *Javitch v. Transamerica Occidental Life Ins. Co.*, 408 F. Supp. 2d 531, 538 (N.D. Ohio 2006) (“An equity receiver's duties are fashioned and may be modified by the appointing court. Because this Court has expressly given the Receiver's broad authority to pursue claims on behalf of Liberte and the investors, the Receiver is not precluded from these actions under the doctrine of *in pari delicto*.”); *Isp.com LLC v. Theising*, 805 N.E.2d 767, 773 (Ind. 2004) (“The receiver is in some respects a new entity, untainted by the corporation's wrongdoing. He is not necessarily barred by *in pari delicto*.”).

⁷¹⁶ Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006), cert. denied, 549 U.S. 811 (2006).

emphasized the distinction between the prepetition debtor company and a trustee or litigation trust for purposes of the defense. They posited that the justifications for the *in pari delicto* doctrine, as articulated above, simply did not apply in the trustee context. In fact, they noted that innocent creditors actually were being penalized because, outside of bankruptcy: (i) state law receivers and receivers appointed by the Securities and Exchange Commission or the Federal Depository Insurance Company could pursue claims previously belonging to the alleged company wrongdoer and not be subject to the defense;⁷¹⁷ and (ii) individual creditors harmed by the wrong could sue the third parties without being subject to the defense.⁷¹⁸ The Commissioners supporting elimination of the *in pari delicto* defense in bankruptcy viewed its enforcement as penalizing the debtor's innocent creditors, who likely were already suffering losses as a result of the bankruptcy itself.

The Commissioners parsed through the likely practical implications of eliminating the *in pari delicto* defense in bankruptcy. The Commissioners acknowledged that including the debtor in possession in the concept of an "estate representative" not subject to the *in pari delicto* defense may raise closer policy issues. Although the debtor in possession has a legal status different from the prepetition debtor under the Bankruptcy Code, the Commissioners acknowledged that the debtor in possession could still employ some of the individuals who allegedly participated on behalf of the debtor in the wrongdoing. They also presented a closer conceptual question on the policy issues. Some of the Commissioners supported including the debtor in possession among the estate representatives that should not be subject to the *in pari delicto* defense.⁷¹⁹ Some of the Commissioners believed it was more important to eliminate the defense, at least as to bankruptcy trustees, and then also as to unsecured creditors' committees, litigation trustees, and similar estate representatives that were not affiliated with the prepetition debtor.

Other Commissioners voiced concern that any change to the current law essentially would create a new cause of action for the estate not otherwise available under state law. These Commissioners focused on the fact that the debtor (or an entity acting on behalf of the debtor) generally could not pursue such claims under nonbankruptcy law, unless a receiver was appointed.⁷²⁰ They believed that eliminating the *in pari delicto* defense in bankruptcy directly conflicted with the long-standing principle that bankruptcy does not enhance a debtor's rights in property.⁷²¹ From that principle flow the equally important concepts that the estate's interest in property is limited to that held by the debtor prepetition, and that the trustee steps into the debtor's shoes with respect to those property interests and is subject to any defenses otherwise applicable against the debtor.⁷²² These Commissioners could

717 *O'Melveny & Myers v. FDIC*, 512 U.S. 79 (1994) (remanding on grounds that state law should determine if defense applies). On remand, the Ninth Circuit held that the defense did not apply to receiver even under California law. *FDIC v. O'Melveny & Myers*, 61 F.3d 17 (9th Cir. 1995). See also *Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995), cert. denied, 516 U.S. 1028 (1995) ("Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.").

718 *FDIC v. O'Melveny & Myers*, 61 F.3d 17, 19 (9th Cir. 1995) ("While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law. Moreover, when a party is denied a defense under such circumstances, the opposing party enjoys a windfall. This is justifiable as against the wrongdoer himself, not against the wrongdoer's innocent creditors.").

719 These Commissioners noted that, in most cases, management of the old debtor has been replaced or a Chief Restructuring Officer has been appointed.

720 These Commissioners noted that the receiver context was different than the collective action process of bankruptcy and believed that the different treatment was justified on that basis.

721 See, e.g., S. Rep. No. 95-989, at 82 (1978), reprinted in 1978 U.S.C.C.A.N. 5787; H.R. Rep. No. 95-595, at 367-68 (1977), reprinted in 1978 U.S.C.C.A.N. 5963 (explaining that section 541 cannot "expand the debtor's rights against others more than they exist at the commencement of the case").

722 See, e.g., *McNamara v. PFS (In re Personal & Bus. Ins. Agency)*, 334 F.3d 239, 245 (3d Cir. 2003) ("[I]n actions brought by the trustee as successor to the debtor's interest under section 541, the 'trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] the trustee is, of course, subject to the same defenses as could have

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not reconcile these principles with the elimination of the *in pari delicto* defense. They also pointed to the inherent unfairness of allowing the principal wrongdoer, or someone standing in the shoes of the wrongdoer, to prosecute a claim against a party who may have been negligent when the wrongdoer's conduct was intentional (*i.e.*, the defendant is liable to the plaintiff because it negligently failed to detect the plaintiff's intentionally concealed fraud).

These Commissioners objected not only to eliminating the defense as to a debtor in possession but also as to the trustee and any other estate representative. They argued that it would be bad policy to allow an estate representative to pursue professionals and institutions on claims that may lack merit and for which one of the alleged wrongdoers — the debtor — is not subject to collection actions. They suggested that such a proposal would encourage “shakedowns” and unfounded settlements because defendants would be forced to settle (regardless of merit) to avoid the risk of potentially significant liability. They likewise noted that eliminating the defense could skew incentives and create unintended challenges for professionals in the distressed industry.

The Commissioners supporting the elimination of the *in pari delicto* defense in bankruptcy focused on the parties represented by the trustee in bankruptcy — *e.g.*, typically general unsecured creditors. They repeatedly emphasized that these creditors are innocent in the process and generally harmed by the types of wrongful conduct alleged in lawsuits in which third parties may assert the *in pari delicto* defense. They suggested that eliminating just the *in pari delicto* defense and preserving a defendant's other defenses would strike the appropriate balance between the bankruptcy policy of allowing an estate representative to pursue claims to maximize the value of the estate for the benefit of creditors and allowing parties to appropriately defend themselves in unfounded litigation. From this perspective, allowing defendants to assert the *in pari delicto* defense against the bankruptcy trustee would place the trustee (and creditors) at a significant disadvantage and provide defendants with a shield that they would not be able to use under state or federal receivership law.

The Commission explored several alternatives for bridging the disparate views of the Commissioners on this issue. Some of the Commissioners suggested a compromise of a federal comparative default rule for these actions, wherein the *in pari delicto* defense would not be available, but defendants could assert that the debtor or its management was primarily at fault. Others suggested modifications to this proposal that would allow defendants to assert that they should not be liable because they were not primarily at fault (*i.e.*, the debtor or another defendant was primarily at fault). The Commissioners expressed concern that this approach would only result in finger-pointing and not serve the purpose of compensating the estate and creditors for prepetition wrongs against their interests.

The Commission then attempted to identify areas of agreement to build consensus on this issue. First, the Commissioners discussed allowing individual creditors to pursue claims that they in fact hold under applicable nonbankruptcy law against third parties allegedly acting in concert with the prepetition debtor free of the *in pari delicto* defense (which would not be applicable in any event) in the bankruptcy case. The Commissioners were generally comfortable with this approach,

been asserted by the defendant had the action been instituted by the debtor.”) (quoting Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001)); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir. 1995) (“[T]he trustee stands in the shoes of the debtors, and can only maintain those actions that the debtors could have brought prior to the bankruptcy proceedings.”).

provided that any recoveries were available only to those creditors holding the claims. Second, the Commissioners discussed allowing a creditor or creditors to pursue such claims in the bankruptcy case on behalf of all creditors when a generalized harm existed. The Commission was fairly evenly split on this component, with some arguing that, in substance, it was no different than allowing an estate representative to bring the claim free of the *in pari delicto* defense.

After extensive deliberation, the Commission recommended the elimination of the *in pari delicto* defense solely with respect to any trustee appointed in the chapter 11 case. The Commission determined that this modification would provide the trustee with rights similar to those possessed by receivers in other contexts, and it would not expose defendants to claims brought by a party controlled or influenced by alleged wrongdoers (*e.g.*, directors, officers, or employees of the debtor). The Commission viewed this as an extension of the potential liability of defendants outside of bankruptcy, where creditors (or a receiver on behalf of creditors) could assert claims not subject to the *in pari delicto* defense, and not as a significant expansion of the trustee's powers against the defendants in bankruptcy. The Commission did not reach a position with respect to the availability of the *in pari delicto* defense in actions brought by other estate representatives, the debtor in possession, or unsecured creditors' committees. Accordingly, the Commission is not making a proposal on the *in pari delicto* defense in actions brought by those entities in the chapter 11 case.

2022 ANNUAL SPRING MEETING

AMERICAN BANKRUPTCY INSTITUTE



VI. PROPOSED RECOMMENDATIONS: EXITING THE CASE

A. General Authority of Debtor in Possession and Its Board of Directors

1. Preemption and the Authority to Approve Transactions and Plan

Recommended Principles:

- A debtor in possession's board of directors or similar governing body should be able to act on behalf of the debtor in possession in the chapter 11 case without seeking or obtaining approval of the debtor's equity security holders, including with respect to transactions under section 363 of the Bankruptcy Code. Accordingly, the Bankruptcy Code should preempt any applicable state entity governance law on these matters, and section 1107 should be amended.
- An order of the court confirming a plan under section 1129 of the Bankruptcy Code should govern the implementation of all transactions contemplated by the plan in accordance with section 1123(a)(5) and preempt any applicable nonbankruptcy law. Sections 1141 and 1142 should be amended to clarify this point.
- The preemptive effect of the chapter 11 plan, confirmation order, or section 363x sale order with respect to transactions included therein should not relieve the directors, officers, or similar managing persons of the debtor, debtor in possession, or reorganized debtor of their fiduciary duties under applicable state entity governance law in implementing or affecting any transactions under the plan or sale order.

Preemption and the Authority to Approve Transactions and Plan: Background

In general, the Bankruptcy Code defers to state law governance principles with respect to the fiduciary duties of a debtor in possession's⁷²³ governing body, whether a board of directors, board of managers, or similar concentrated management structure, as well as its directors, officers, or similar managing persons.⁷²⁴ As discussed above, this deference generally means that those individuals or entities owe the duties of care and loyalty, and an obligation of good faith.⁷²⁵ These state law duties and obligations govern the conduct of those individuals or entities in operating the business and managing its affairs. In addition, state or other applicable nonbankruptcy law may require the debtor

⁷²³ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁷²⁴ See, e.g., David A. Skeel, *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 Tex. L. Rev. 471, 491 (1994) (explaining tradition deference to state governance law). See also *Fogel v. U.S. Energy Sys., Inc.*, 2008 WL 151857, at *1 (Del. Ch. Jan. 15, 2008) (“[C]orporate governance does not cease when a company files a petition under Chapter 11 and that issues of corporate governance are best left to the courts of the state of incorporation.”).

⁷²⁵ See Section IV.A.1, *The Debtor in Possession Model*.

in possession or its governing body to obtain approvals or satisfy specified conditions before taking certain actions for, or on behalf of, the debtor.

For example, state law or the debtor's charter may require the debtor's board of directors to obtain the approval of shareholders before selling all or substantially all of the debtor's assets.⁷²⁶ State law also may require the board of directors to hold an annual shareholders meeting. Although courts commonly allow a debtor in possession to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code without seeking or obtaining shareholder approval, courts have taken a different approach to the shareholders meeting requirement. Most courts review a demand on the debtor in possession to hold the annual shareholders meeting under a "clear abuse" standard, which considers whether the shareholders' rights to vote for directors "and thus to control corporate policy . . . will not be disturbed unless a clear case of abuse is made out."⁷²⁷ Some courts have, however, enjoined the shareholders meeting or denied a shareholder's request to compel the meeting when the strategic objectives of the requesting shareholders are determined to be adverse to the interests of the estate.⁷²⁸

Additionally, a debtor's chapter 11 plan will likely propose a new capital structure and new board members or managers, and it may propose a merger or other change in control transaction, as well as other various actions required or permitted by section 1123 of the Bankruptcy Code. Section 1123(a)(5) specifically provides:

(a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall —

...

(5) provide adequate means for the plan's implementation, such as —

- (A) retention by the debtor of all or any part of the property of the estate;
- (B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;
- (C) merger or consolidation of the debtor with one or more persons;
- (D) sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;
- (E) satisfaction or modification of any lien;
- (F) cancellation or modification of any indenture or similar instrument;
- (G) curing or waiving of any default;

⁷²⁶ See *Esopus Creek Value LP v. Hauf*, 913 A.2d 593, 596, 605–06 (Del. Ch. 2006). See also Del. Code Ann. tit. 8, § 271(a) (2008) (requiring a majority of shareholders to approve the sale of all or substantially all of a corporation's property and assets).

⁷²⁷ *Fogel v. U.S. Energy Sys., Inc.*, 2008 WL 151857, at *1 (Del. Ch. Jan. 15, 2008) (citing *In re Lionel Corp.*, 30 B.R. 327, 329–30 (Bankr. S.D.N.Y. 1983)).

⁷²⁸ See, e.g., *Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60 (2d Cir. 1986) (discussing court's ability to limit shareholders' rights during chapter 11 case).

- (H) extension of a maturity date or a change in an interest rate or other term of outstanding securities;
- (I) amendment of the debtor's charter; or
- (J) issuance of securities of the debtor, or of any entity referred to in subparagraph (B) or (C) of this paragraph, for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose;⁷²⁹

The legislative history of section 1123(a)(5) provides that the section is “intended to indicate that a plan may provide for any action specified in section 1123 in the case of a corporation without a resolution of the board of directors” and, if confirmed, “any action proposed in the plan may be taken notwithstanding any otherwise applicable nonbankruptcy law in accordance with section 1142(a) [of the Bankruptcy Code].”⁷³⁰

The phrase “[n]otwithstanding any otherwise applicable nonbankruptcy law” was added to section 1123 in 1984 to clarify the preemptive nature of the section. Nevertheless, the Ninth Circuit Court of Appeals has read section 1123(a)(5) narrowly to limit its preemptive effect to the scope of section 1142(a), which arguably is limited to “applicable nonbankruptcy law, rule, or regulation relating to *financial condition*.”⁷³¹ Other courts have, however, declined to graft section 1142(a)'s limitation onto section 1123(a), noting that Congress used different language in section 1123(a), even though it was aware of section 1142(a)'s language at the time of the amendment.⁷³²

Preemption and the Authority to Approve Transactions and Plan: Recommendations and Findings

State entity governance law continues to play an important role in the debtor's operations postpetition and postconfirmation. In light of the Bankruptcy Clause of the U.S. Constitution⁷³³ and well-established principles of federal preemption, however, there are instances in which state entity governance law and other related law must yield to the Bankruptcy Code. The Commission endeavored to clarify these boundaries and better articulate the debtor in possession's ability to transact business during the chapter 11 case.

The Commissioners discussed areas of the federal bankruptcy law and state entity governance law that might conflict, focusing on sale transactions, plan implementation, and equity security holders

⁷²⁹ 11 U.S.C. § 1123(a)(5). See also 7 Collier on Bankruptcy ¶ 1123.01[5] (16th ed. 2009) (“The types of means listed in section 1123(a)(5) are clearly illustrative and not exclusive.”).

⁷³⁰ Section 1142(a) provides: “Notwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation relating to financial condition, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court.” 11 U.S.C. § 1142(a).

⁷³¹ *In re Pac. Gas & Elec. Co. v. Cal. Dep't of Toxic Substances Control*, 350 F.3d 932, 949 (9th Cir. 2003), *cert. denied*, 543 U.S. 956 (2004).

⁷³² *In re Renegade Holdings, Inc.*, 429 B.R. 502 (Bankr. M.D.N.C. 2010) (declining to follow *Pacific Gas*). See also *In re Federal-Mogul Global Inc.*, 684 F.3d 355 (3d Cir. 2012) (same); *In re FCX, Inc.*, 853 F.2d 1149, 1155 (4th Cir. 1988), *cert. denied*, 489 U.S. 1011 (1989) (holding that section 1123(a)(5) is an “empowering statute” that “does not simply provide a means to exercise the debtor's pre-Bankruptcy rights; it enlarges the scope of those rights”); *In re Stone & Webster, Inc.*, 286 B.R. 532, 543 (Bankr. D. Del. 2002) (explaining that “the provisions of a plan as articulated in § 1123(a) can be effected without regard to otherwise applicable nonbankruptcy law, including the corporation law of the State of Delaware or any other state corporation laws having bearing on the debtors”).

⁷³³ U.S. Const. art. I, § 8, cl.4.

meetings. The Commissioners found that courts generally allow debtors in possession to proceed with section 363 sales of all or substantially of its assets without any equity security holder approval under applicable state law or the debtor's organizational documents. The Commissioners discussed the protections for stakeholders provided by the Bankruptcy Code in the sale context, including the new principles proposed for section 363x sales. They also considered the delay and uncertainty introduced into the process by requiring an equity security holders' vote, the fact that equity security holders are often out of the money in these cases, and the ability of equity security holders to object or otherwise be heard on the proposed sale under sections 1109 and 363 of the Bankruptcy Code. The Commission agreed that the Bankruptcy Code should be amended to clarify the ability of the board of directors or similar governing body to pursue and consummate section 363 transactions without approvals required by state entity governance law, including an equity security holders' vote.

The Commissioners also discussed the different approaches of courts to a debtor in possession's obligations under state law to hold annual or special shareholders' meetings. The Commissioners recognized that complying with an annual meeting requirement, or responding to a shareholder's request for a special meeting, may impose costs on the estate and delay the case. They did not believe, however, that a general prohibition on shareholders' meetings during chapter 11 cases was an appropriate response. When the debtor acting as such for the benefit of its shareholders (as opposed to the debtor in possession acting as representative of the estate; *see* next section) may propose a plan, it may be inappropriate to deny the shareholders the right to elect the directors who are representing the shareholders' interests. The Commission determined that this issue was best resolved by courts under the current law and the facts of the particular case.

In addition, the Commissioners discussed the interplay of bankruptcy law and applicable nonbankruptcy law in the context of transactions necessary to implement, or contemplated by, a chapter 11 plan. The Commission reviewed the case law on the scope and application of section 1123(a), and along with 1984 amendment suggesting that Congress was expressly preempting nonbankruptcy law in that particular context. Indeed, "notwithstanding" is one of the most common indicators of expressed preemption, discarding any need to consider whether implied preemption was intended. The Commission considered whether there was a justification for linking the section 1123(a) preemption to the more limited preemption suggested in the section 1142(a) context. Notably, section 1123(a) speaks to matters necessary to obtain confirmation of the plan and to then implement the transactions, transfers, and distributions contemplated in the confirmed plan. The Commission agreed with those courts interpreting section 1123(a) as an empowering statute and recommended that sections 1141 and 1142 be amended to clarify the preemptive effect of that section.

2. Role of Debtor in Plan Process

Recommended Principles:

- Section 1121 of the Bankruptcy Code should be amended to clarify that a debtor, in its capacity as such and as a plan proponent, is required to comply only with

its fiduciary duties under applicable state entity governance law in negotiating, drafting, and seeking confirmation of a chapter 11 plan.

- Section 1121 should be amended to clarify that a debtor in possession's board of directors, officers, or similar managing persons act as fiduciaries for the debtor in connection with the plan process (including, but not limited to, formulation, confirmation, and consummation of the plan), and applicable state law fiduciary duties should continue to govern their conduct.
- In addition, to foster efficient and effective representation, professionals for the debtor in possession should be able to represent the debtor in possession in its capacity as an estate fiduciary and in its separate capacity as a debtor and plan proponent without violating section 327. Accordingly, section 327 should be amended to clarify this point.
- For a discussion of the fiduciary duties of the debtor in possession's board of directors, officers, or similar managing persons, see Section IV.A.1, *The Debtor in Possession Model*.

Role of Debtor in Plan Process: Background

When a company files a chapter 11 case, it assumes the role of debtor in possession, which has certain rights, powers, and duties different from the prepetition debtor. Specifically, under section 1107 of the Bankruptcy Code, the debtor in possession has the rights, powers, and duties of a bankruptcy trustee. The debtor in possession is also a fiduciary for the estate. Most provisions of the Bankruptcy Code relevant to a chapter 11 case authorize the trustee, and in turn the debtor in possession, to take certain actions and exercise certain rights.⁷³⁴ Other provisions that require disclosures, impose obligations, or concern creditors' rights in the case tend to apply to, or reference, the debtor. One important exception to this general categorical divide is section 1121 of the Bankruptcy Code, which provides that "[t]he debtor may file a plan with a petition commencing a voluntary case, or at any time in a voluntary case or an involuntary case." Moreover, "only the debtor may file a plan until the 120 days after" the petition date.

The legislative history of section 1121 focuses primarily on mitigating the practices under Chapter XI of the Bankruptcy Act that did not allow nondebtor parties to submit a plan of reorganization.⁷³⁵ Congress was concerned that complete exclusivity in the plan context might hold creditors hostage

⁷³⁴ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁷³⁵ One court cited the legislative history of the Bankruptcy Act in support of creditor involvement:

Within certain limits, the Chapter XI debtor can effectively dictate the essential ingredients of a Chapter XI plan to its creditors. In many cases, the alternative to creditors may be to accept the proverbial 'ten cents on the dollar' offered or be confronted with an adjudication in bankruptcy and the resultant liquidation. . . . The substantial loss that may be faced by creditors as a consequence of the forced auction sale of work in process, inventory, machinery and plant may be overwhelming. . . .

The take-it-or-leave-it attitude on the part of debtors as permitted by Chapter XI is fraught with potential abuse. The granting of authority to creditors to propose plans of reorganization and rehabilitation serves to eliminate the potential harm and disadvantages to creditors [and] democratizes the reorganization process.

and subject them to unfavorable treatment in the plan.⁷³⁶ Nevertheless, Congress recognized that the debtor was in the best position to serve as an honest broker and to negotiate a consensual plan. There is some suggestion that Congress was also concerned with providing appropriate incentives for prepetition management to invoke chapter 11 and to use the plan process to rehabilitate the debtor's business.

Although the company's directors and officers remain the same whether it is serving as the debtor or the debtor in possession, the Bankruptcy Code arguably contemplates different roles for these two entities. Some courts interpret the language of the Bankruptcy Code as endorsing this approach, and they treat the debtor and the debtor's fiduciary duties differently than those of the debtor in possession. For example, the court in *In re Water's Edge* determined that the debtor in possession, acting as the debtor and plan proponent under sections 1121, 1127, 1129, 1141, and 1142, had no fiduciary duties to the estate.⁷³⁷ The court explained:

A debtor in possession [as a debtor/plan proponent] is therefore permitted to place its own interests above those of the unsecured creditors with respect to what it proposes to pay under its plan. This is of course inconsistent with the concept that the debtor in possession is a fiduciary of the unsecured creditors owing them a duty of loyalty. The conclusion seems inescapable. As to its proposed plan dividend, a debtor in possession is not a fiduciary of the unsecured creditors owing them a duty of loyalty. Its bargaining and cramdown rights necessarily exclude such a fiduciary obligation.⁷³⁸

Other courts are imprecise in discussing the debtor's or debtor in possession's roles in the plan process, and some have determined that the debtor in possession continues to owe duties to the estate in formulating and filing a plan. In addition, this confusion often spills over to the role and duties of the debtor in possession's professionals.⁷³⁹

Role of Debtor in Plan Process: Recommendations and Findings

Under section 1121 of the Bankruptcy Code, the debtor, as distinct from the debtor in possession, may file a chapter 11 plan. This distinction is important given the often competing and conflicting interests present in the bankruptcy estate and the challenges that a debtor would face if required

In re Lake in the Woods, 10 B.R. 338, 344 (E.D. Mich. 1981) (quoting Bankr. Act Revision, Serial No. 27, Part 3, Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary, 94th Cong., 2d Sess., at 1875–76 (Mar. 29, 1976) (statement of H. Miller, W. Rochelle and J. Trost)).

736 The Fifth Circuit explained the imbalance between debtors and their creditors that section 1121 was designed to mitigate:

While we are not called upon here to decide what factors constitute “cause” for the extension of the exclusivity period, we think that any bankruptcy court involved in an assessment of whether “cause” exists should be mindful of the legislative goal behind Section 1121. The bankruptcy court must avoid reinstituting the imbalance between the debtor and its creditors that characterized proceedings under the old Chapter XI. Section 1121 was designed, and should be faithfully interpreted, to limit the delay that makes creditors the hostages of Chapter 11 debtors.

United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd. (In re Timbers of Inwood Forest Assocs., Ltd.), 808 F.2d 363, 372 (5th Cir. 1987), *aff'd*, 484 U.S. 365 (1988).

737 *In re Water's Edge Ltd. P'ship*, 251 B.R. 1, 7 (Bankr. D. Mass. 2000).

738 *Id.* at 8.

739 See, e.g., *Hansen, Jones & Leta, P.C. v. Segal*, 220 B.R. 434, 459–60 (D. Utah 1998).

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to negotiate and draft a chapter 11 plan that satisfied some fiduciary duty to these competing stakeholders.⁷⁴⁰

The Commission considered the continued utility of the distinction between the debtor and the debtor in possession in the plan process context. The Commissioners observed that the debtor as a plan proponent must consider the interests of the company and the company's obligations to creditors and equity security holders in developing its chapter 11 plan. In this capacity, the debtor may be called upon to make difficult decisions concerning the business, its workforce, its assets, and its relationships with stakeholders. Although the debtor will negotiate with key stakeholders and attempt to achieve a consensus on its plan, it may not be able to start (or end) those negotiations with a plan structure that primarily benefits creditors alone. Moreover, what is in the best interests of creditors may not necessarily be in the best long-term interests of the company or its equity security holders in the plan context.

The Commissioners analyzed whether it would be feasible for a debtor in possession to serve multiple masters by acting as a fiduciary for equity security holders and creditors in the plan process. The Commissioners discussed the potential conflicts of interests and competing objectives that could paralyze a debtor in possession acting in this dual role. A debtor in possession should not be placed in the position of negotiating a plan for the company and its equity security holders with the creditors whose interests the debtor in possession represents as a fiduciary of the estate. A party negotiating on behalf of different parties in the same deal rarely produces the best or a fair result. Accordingly, the Commission agreed that the debtor should be separated from the debtor in possession in the plan context, and that the debtor acting as plan proponent should not be considered a fiduciary for the creditors.

The Commissioners then discussed what fiduciary duties, if any, the debtor's directors, officers, or similar managing persons should owe in the plan process. They reviewed a proposal by Stephen Case that would allow the debtor to select the beneficiary for its duties — *e.g.*, shareholders, creditors, etc.⁷⁴¹ Although that approach would provide certainty to the process, the Commissioners expressed concerns about strategic maneuvers, collusion, and conflicts with state entity governance law. As such, the Commissioners found that the most efficient approach would be to impose whatever duties applicable state entity governance law would impose in these circumstances. This approach also would be consistent with other duty-related principles discussed by the Commission. In addition, the Commission agreed that professionals for the debtor in possession should not be disqualified from representing the debtor in the plan process solely on the basis that such professionals were representing the debtor in two different capacities. The Commissioners acknowledged that requiring separate professionals would impose unnecessary and likely duplicative costs on the estate with no real advantages, provided that the professionals otherwise were disinterested and satisfied section 327 or 328 of the Bankruptcy Code.

⁷⁴⁰ See, *e.g.*, *Written Statement of Thomas J. Salerno: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Nov. 7, 2013) ("[C]ertain provisions of the Bankruptcy Code related to the plan negotiation process appear inconsistent with imposition of a duty of loyalty to creditors of the estate occurring in plan negotiations. In light of these provisions, and the sheer impossibility of absolute loyalty to two adverse interests in the negotiating process, it appears that directors and officers are not held, and should not be held, to the same fiduciary duty of loyalty to the estate in the negotiation of a plan."), *available at* Commission website, *supra* note 55.

⁷⁴¹ See Stephen H. Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases* 13, in C371 A.L.I.-A.B.A. 1, 17 (Study Materials for A.L.I.-A.B.A.'s Williamsburg Conference on Bankruptcy, Oct. 17–19, 1988) (explaining that the duty of impartiality imposed on directors of a debtor in possession should permit those directors to elect to act in a pro-creditor, pro-equity, or stakeholder mediator capacity).

B. Approval of Section 363x Sales

Recommended Principles:

- The court should approve a sale of all or substantially all of a debtor's assets only if the court finds by a preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements:
 - The sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(1).)
 - The proponent of the sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(2).)
 - The sale has been proposed in good faith and not by any means forbidden by law. (Comparable plan provision found at 11 U.S.C. § 1129(a)(3).)
 - Any payment made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in or in connection with the case, or in connection with the sale and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable. (Comparable plan provision found at 11 U.S.C. § 1129(a)(4).)
 - Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the trustee proposes to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of a kind specified in section 507(a)(2) or (3) incurred through the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(9)(A).)
 - All fees payable under section 1930 of title 28 of the U.S. Code, as determined by the court at the hearing on the sale, have been paid or the trustee provides for the payment of all such fees on the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(12).)
 - The trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection for the purchaser in the order approving the sale.
- A section 363x sale is subject to the principles on orders resolving chapter 11 cases. See Section VI.G, *Orders Resolving Chapter 11 Case (Exit Orders)*.
- These principles refer to “a sale of all or substantially all of a debtor's assets” as a “**section 363x sale**.” For the timing of section 363x sales, see Section IV.C.2, *Timing of Section 363x Sales*.
- The other recommended principles relating to transactions outside the ordinary course also apply in the section 363x sale context. See Section V.B, *Use, Sale, or Lease of Property of the Estate*.

Approval of Section 363x Sales: Background

As explained above, a debtor in possession⁷⁴² may seek to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code.⁷⁴³ This kind of sale (referred to in these principles as a “section 363x sale”) is a value realization event in the chapter 11 case, as it involves monetizing nearly all of the assets available to satisfy claims against and interests in the estate. Because a section 363x sale terminates the estate’s and, in turn, creditors’ interests in the assets, the process to facilitate such a sale is critically important to the recoveries ultimately received by creditors. The timing of a section 363 sale can significantly impact value and raises notice and due process concerns; timing issues are addressed separately above.⁷⁴⁴

A section 363x sale transforms the estate from illiquid assets with fluctuating value to a fixed sum of money or securities.⁷⁴⁵ Consequently, it potentially alters the value of the estate in a positive or negative direction, depending on factors such as the timing of the sale, the marketing of the assets, the competitive nature of the auction, and the sale and restructuring alternatives explored by the debtor in possession leading up to the section 363x sale. Anecdotal evidence suggests that section 363x sales can facilitate quicker sales that create value for the estate.⁷⁴⁶ Such evidence also suggests, however, that a bidder may pursue certain strategies such as a “loan-to-own” strategy or streamlined sale process that may chill bidding and depress the value of the assets.⁷⁴⁷

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

743 See Section V.B, *Use, Sale, or Lease of Property of the Estate*. See also George W. Kuney, *Let’s Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 Hous. L. Rev. 1265, 1267–68 (2004) (discussing increasing use of chapter 11 to sell assets).

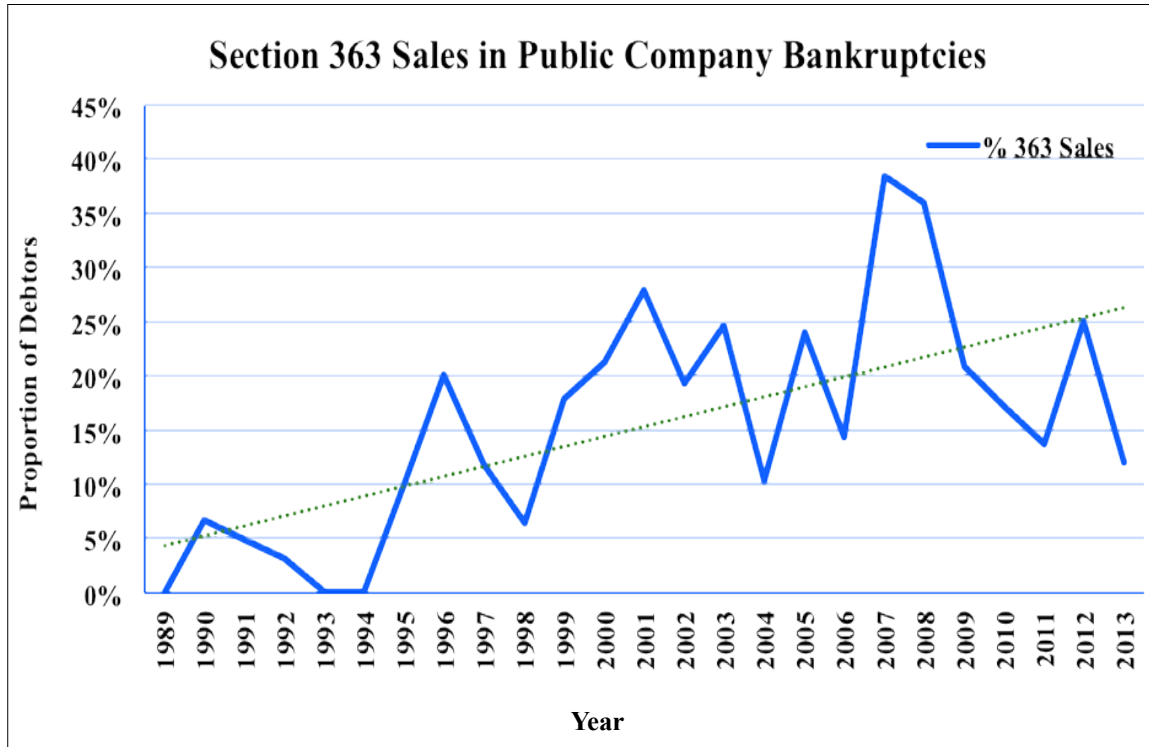
744 See Section IV.C.2, *Timing of Section 363x Sales*.

745 See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11 (Oct. 8, 2013) (describing the potential negative consequences to creditors and, in turn, problems with sales of substantially all of a debtor’s assets under section 363), available at Commission website, *supra* note 55.

746 For a thorough discussion of the competing perspectives on section 363 sales of all or substantially all of a debtor’s assets in chapter 11, see *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 419 (Bankr. S.D. Tex. 2009) (reviewing the relevant case law, treatises, and academic literature). See also Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012) (“Increasingly, distressed companies have also taken advantage of Chapter 11 as a more efficient way to sell assets.”); Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales). See generally Section IV.C.2, *Timing of Section 363x Sales*.

747 See, e.g., Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives*, 16 Am. Bankr. L. Rev. 69 (2008) (reporting results of empirical survey on, among other issues, investors’ loan-to-own strategies in bankruptcy). See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). See also Jonathan M. Landers, *Reflections on Loan-to-Own Trends*, Am. Bankr. Inst. J., Oct. 2007, at 44–46 (explaining loan-to-own transactions); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 513 (2009) (discussing, among other things, impact of creditor control on the decision to sell assets in bankruptcy); Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115 (“Controlling secured lenders often use chapter 11 as a vehicle to foreclose on their assets. Traditional corporate reorganizations are becoming a *rara avis*; the strongly emerging norm is for debtors to be liquidated in speedy ‘§ 363 sales,’ the reference being to the Bankruptcy Code section authorizing sales. This practice has become so prevalent that a coauthor and I have spoken of the ‘new ‘Chapter 3’ reorganization.”); Brubaker, *Credit Bidding and the Secured Creditor’s Baseline Distributional Entitlement in Chapter 11*, *supra* note 542, at 10 (“The ‘loan to own’ phenomenon has caused some to question the advisability of credit bidding. The basic concern seems to be that a ‘loan to own’ lender’s primary incentive is, unlike a traditional lender, acquiring the debtor’s assets as cheaply as possible, rather than maximizing the recovery on its secured loan. A traditional lender has every incentive to maximize the sale price of its collateral through vigorous competitive bidding, sincerely hoping that bid prices will exceed the amount it could credit bid with its existing secured loan, as this would mean a full recovery on that loan. A ‘loan to own’ lender, though, has every incentive to inhibit competitive bidding in order to ensure that bid prices will not exceed the amount it can credit bid with its existing secured loan, as this would mean that the ‘loan to own’ lender can acquire the debtor’s assets solely through a credit bid of its existing secured loan and with no additional investment.”); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 846 (2004) (“In both judicial and private auction sales, there are often strict requirements for a bidder other than the secured party. In particular, the bidder may have to bring sufficient cash to cover its bid or to provide cash payment very shortly after the bidding. For this and other reasons, it is often the case that few other bidders appear at foreclosure and repossession sales. This fact combines with the bidding-in rules to make it possible for secured parties to buy at their own sales at a price well below market value while avoiding sanctions for violating Article 9’s notice and sale procedures.”).

The limited empirical data on section 363x sales are mixed in results and difficult to interpret because the coding of the debtor's exit strategy as a liquidation, going concern sale (*i.e.*, section 363x sale), or confirmed plan often is very subjective, and the data are “noisy” in this respect.⁷⁴⁸ It also is challenging for empiricists to collect and code creditors' recoveries, particularly in cases that do not have publicly traded securities. In fact, much of the data on chapter 11 cases speak only to the large chapter 11 cases.⁷⁴⁹ For example, the chart shown below demonstrates a positive linear trend (illustrated by the dotted line) in the number of section 363 sales in chapter 11 cases, but it also is limited to large public companies.⁷⁵⁰



⁷⁴⁸ See, e.g., Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (study analyzing large public company bankruptcy cases and finding that recoveries in reorganization cases are more than double recoveries from going concern sales); James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691 (2007) (critiquing the LoPucki & Doherty study and finding no statistical difference between sale prices and reorganization prices); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 Mich. L. Rev. 721 (2008) (responding to the White study). See also, e.g., Jenkins & Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization*, *supra* note 42 (developing model to assess efficient and inefficient liquidations in bankruptcy and concluding that about 8 percent of firms are inefficiently liquidated — *i.e.*, they were liquidated when it would have been more efficient to reorganize); Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. Fin. Intermediation, 240–262 (1998) (providing “empirical evidence that takeovers can facilitate the efficient redeployment of assets of bankruptcy firms”). See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

⁷⁴⁹ For example, many chapter 11 empirical studies use the UCLA-LoPucki Bankruptcy Research Database or a similarly restricted database. The UCLA-LoPucki Bankruptcy Research Database includes all bankruptcy cases filed between 1980 and 2012 by or against a business debtor or group of affiliated debtors that had assets worth \$100 million or more, measured in 1980 dollars.

⁷⁵⁰ Mr. Shrestha prepared this chart for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The chart analyzes all Section 363 Sales in the UCLA-LoPucki Bankruptcy Research Database (including confirmed, pending, converted, and dismissed cases). Because certain of the cases included in this analysis did not include data for the date of the sale order, some of these data are not included in the chart describing the median duration between the petition date and sale order date in bankruptcy cases. See Section IV.C.2, *Timing of Section 363x Sales*. But see Jay Lawrence Westbrook, *The Role of Secured Credit in Chapter 11 Cases: An Empirical Review*, 2015 Ill. L. Rev. ___, at *6 (forthcoming 2015) (finding, in an empirical study of 424 cases covering a broad cross section of chapter 11 debtors in nine districts, that only about 25 percent of cases and any sales out of the ordinary course, suggesting that section 363 sales are less common than previously thought) (draft on file with Commission). See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

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Moreover, chapter 11 cases — unlike consumer bankruptcy cases — often present unique facts and involve dynamics not reflected on the court docket. Accordingly, although the data are extremely informative, they should be read with caution, and any claims of causality should be critically analyzed given the foregoing factors and related research limitations (e.g., endogeneity bias, sample selection bias) that may impact research issues in this area.⁷⁵¹

As suggested above, a section 363x basically determines the maximum recovery any particular creditor will receive in the case. In a case where the debtor's assets are sold for less than the value of the secured claims asserted against the estate, junior creditors — including those holding prepetition unsecured claims and, potentially, postpetition administrative claims relating to the administration of the case following the sale — may not receive any distributions. Although a debtor that liquidates in chapter 11 does not receive a discharge, for all practical purposes, a section 363x essentially discharges the primary source of recovery in business cases (*i.e.*, the debtor's assets).

Accordingly, many courts raise concerns regarding section 363x sales in chapter 11 cases. Among other things, courts and commentators note that these sales skirt the notice and due process protections of the plan process, are often pursued before parties in interest have adequate information to assess the sale and a debtor's restructuring alternatives, and may determine ultimate distributions to creditors without creditors having a vote or the protections of the "fair and equitable" standard of section 1129(b).⁷⁵² Nevertheless, as many of these courts recognize, a debtor in possession may have no viable restructuring alternatives, and the section 363x sale may in fact represent its best opportunity for providing recoveries to at least some stakeholders. In these circumstances, many courts strive to make a going concern sale work under the current Bankruptcy Code, but it was not an intended, and thus is not a perfect, fit.⁷⁵³

Approval of Section 363x Sales: Recommendations and Findings

Some commentators argue that a sale of all or substantially all of a debtor's assets is akin to a traditional reorganization in that it is a change-of-control event that facilitates distributions of value to creditors and frequently continues the business of the debtor in some form. The Commissioners debated this general proposition at length. Although the Commissioners held differing views on what qualifies as "reorganization" under chapter 11, many of the Commissioners believed that sales of all or substantially all of a debtor's assets have become part of the restructuring landscape. As such, the Commission agreed that the most constructive approach to the issue was to analyze critically the sale process, recognizing the potential utility of the process in achieving certain policy goals, including maximizing value for creditors and preserving jobs for at least part of the debtor's workforce.

⁷⁵¹ See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

⁷⁵² See, e.g., *In re Gen. Motors Corp.*, 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re Motors Liquidation Co.*, 430 B.R. 65 (S.D.N.Y. 2010) ("[A] debtor cannot enter into a transaction that 'would amount to a *sub rosa* plan of reorganization' or an attempt to circumvent the chapter 11 requirements for confirmation of a plan of reorganization."). *But see* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re Lionel Corp.*), 722 F.2d 1063, 1071 (2d Cir. 1983) ("Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for.").

⁷⁵³ See, e.g., *In re Chrysler LLC*, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010) ("A debtor may sell substantially all of its assets as a going concern and later submit a plan of liquidation providing for the distribution of the proceeds of the sale. This strategy is employed, for example, when there is a need to preserve the going concern value because revenues are not sufficient to support the continued operation of the business and there are no viable sources for financing.").

As discussed above, a key concern among the Commissioners was the timing of section 363x sales, which they believed should be conducted in a methodical manner and on a reasonable timeline so that the debtor can identify, and creditors can confirm, that the sale not only provides the best and highest offer for the assets, but also the best restructuring alternative for the debtor and all of its stakeholders. The Commission recommended a 60-day moratorium on section 363x sales to promote these objectives.⁷⁵⁴

The Commissioners reflected on the meaningful differences between a section 363x sale process and the chapter 11 plan process. They considered both substantive and procedural aspects of the process. For example, courts use slightly different standards of review in approving sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code.⁷⁵⁵ Most courts employ some form of heightened scrutiny, but that review may simply turn on whether the debtor in possession has a "good reason" for the proposed sale under the circumstances of the particular case.⁷⁵⁶ Such a standard is a much different and arguably lower standard than that applied to confirmation of a chapter 11 plan in the cramdown context.⁷⁵⁷ The Commissioners observed that a cramdown analysis generally is applicable because most classes of creditors will be impaired by the sale and receive nominal, if any, distributions from the sale proceeds. Moreover, creditors do not get a "vote" on the sale. To confirm a plan under the section 1129 cramdown standard, a debtor must establish that the plan (i) satisfies

⁷⁵⁴ See Section IV.C.2, *Timing of Section 363x Sales*.

⁷⁵⁵ See *Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1072 (2d Cir. 1983) (reviewing historical standard applicable to bankruptcy sales and finding more flexibility under section 363(b), noting that "[i]n fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike"). See also *In re Whitehall Jewelers Holdings, Inc.*, 2008 WL 2951974, at *6 (Bankr. D. Del. July 28, 2008) ("[W]hen a preconfirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization'" (citation omitted)); *In re George Walsh Chevrolet, Inc.*, 118 B.R. 99, 101 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re Indus. Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (holding that a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a preconfirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business — including provision of proper notice, adequacy of price, and 'good faith' — is heightened").

⁷⁵⁶ See *Comm. of Equity Sec. Holders v. Lionel Corp.* (*In re Lionel Corp.*), 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). See also *In re Boston Generating, LLC*, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010) ("[A] court rendering a section 363(b) determination must 'expressly find from the evidence presented . . . a good business reason to grant such application.'" (citations omitted)); *In re Daufuskie Island Props., LLC*, 431 B.R. 626, 637 (Bankr. D.S.C. 2010) ("Because the sale is one of substantially all assets of the Estate prior to confirmation of a Chapter 11 plan in this case, authorization for the sale under § 363(b)(1) requires that the Trustee satisfy the 'sound business purpose' test for preconfirmation sales."); *In re Gen. Motors Corp.*, 407 B.R. 463, 489 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re Motors Liquidation Co.*, 430 B.R. 65 (S.D.N.Y. 2010) ("[I]t is plain that in the Second Circuit, as elsewhere, even the entirety of a debtor's business may be sold without waiting for confirmation when there is a good business reason for doing so."); *In re Nicole Energy Servs., Inc.*, 385 B.R. 201, 10 (Bankr. S.D. Ohio 2008) ("[T]he Court may approve a sale of all of a debtor's assets under § 363(b) 'when a sound business purpose dictates such action.'").

⁷⁵⁷ *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 16–17 (Nov. 15, 2012) ("Chapter 11 plans of liquidation continue to grow in popularity as a 'reorganization' option but offer less protection to creditors, including secured creditors, than a liquidation under Chapter 7. In almost all cases, once the Chapter 11 plan of liquidation has been confirmed, it is the debtor or liquidating trustee who conducts the liquidation without further input from creditors and often with limited (if any) judicial oversight. As a result, creditors have little or no input into the liquidation decisions made by the liquidating trustee/debtor beyond the information contained in the disclosure statement, and there is no real ability on the part of creditors to oversee the liquidation that is being accomplished — allegedly for their benefit. . . . It is becoming commonplace that courts will not condone a §363 sale which disposes of substantially all of the estate's assets without the court and the creditors being advised as to the terms of 'wind-down' or a plan of liquidation. Similarly, many courts allow for what are referred to as 'structured dismissals' in lieu of either a Chapter 11 plan of liquidation or a conversion to Chapter 7, without any specific statutory underpinning. Without giving any real guidance as to when a Chapter 11 liquidation is appropriate and the level of interaction available to creditors if the Debtor has not complied with the plan or refuses to cooperate, the secured lender is left only with the option of reclaiming its collateral."), available at Commission website, *supra* note 55; See *Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (suggesting higher standard of review for sales under section 363(b) and (f)), available at Commission website, *supra* note 55.

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all of the requirements of section 1129(a) (including good faith, the best interests of creditors test, and payment of all administrative claims and certain priority claims), except section 1129(a)(8); and (ii) does not discriminate unfairly and is fair and equitable with respect to each dissenting impaired class under section 1129(b).⁷⁵⁸

In general, a plan discriminates unfairly against an impaired dissenting class if it provides greater value to a class of claims or interests with equal priority. “In a nutshell, if the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class.”⁷⁵⁹ Section 1129(b)(2) sets forth certain standards that must be met for the plan to be considered fair and equitable as to dissenting impaired classes of secured and unsecured claims and equity interests. The legislative history, however, also makes clear that certain factors that are relevant to the fair and equitable determination are not specified in section 1129.⁷⁶⁰ The most common factor considered in this context is a prohibition on a senior class receiving more than 100 percent of its claim in a cramdown scenario.

In addition to substantive distinctions, the Commissioners observed that, particularly in an expedited sale process, many creditors do not receive notice of the sale or sufficient information to evaluate the sale. Yet the sale may eviscerate any recoveries for unsecured creditors in the case, and could subject some or all of the creditors to third-party releases or discharges that impact the parties and property potentially available to satisfy their claims. The Commissioners believed that more meaningful notice to a broader audience is necessary and appropriate in many cases.

Overall, the Commissioners found little difference in the consequences to creditors’ rights and claims under an order approving a section 363x sale or an order confirming a chapter 11 plan. They did find, however, significant differences in the creditor protections available under the two processes. Considering the potentially greater exposure to loss of value in the sale context where the assets are being removed from the estate, the Commission ultimately determined that creditors should be afforded at least the same level of protection in the section 363x sale process and in the chapter 11 plan process. The proposed procedural principles for section 363x incorporate these recommendations.

⁷⁵⁸ 11 U.S.C. § 1129(a), (b).

⁷⁵⁹ Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, 142 (1979).

⁷⁶⁰ *Id.*

C. Value Determinations, Allocation, and Distributions

1. Creditors' Rights to Reorganization Value and Redemption Option Value

Recommended Principles:

- A class of senior creditors should be entitled to receive in respect of their secured claims distributions under the chapter 11 plan or order approving a section 363x sale having a value equal to the reorganization value (or portion thereof) attributable to the collateral securing their claims as of the effective date of the plan or the date of a section 363x sale order, unless such classes agree to accept different treatment. For purposes of this principle, the term “*reorganization value*” means (i) if the debtor is reorganizing under the plan, the enterprise value attributable to the reorganized business entity, plus the net realizable value of its assets that are not included in determining the enterprise value and are subject to subsequent disposition as provided in the confirmed plan; or (ii) if the debtor is selling all or substantially all of its assets under section 363x or a chapter 11 plan, the net sale price for the enterprise plus the net realizable value of its assets that are not included in such sale and are subject to subsequent disposition as provided in the confirmed plan or as contemplated at the time of the section 363x sale.⁷⁶¹
- The valuation date set by the effective date of a plan or the date of a section 363x sale order should not foreclose, in appropriate cases, a distribution in the chapter 11 case on account of the possibility of future appreciation in the firm's value due to the firm's continuation as a going concern. Although the valuation at any point in time will necessarily reflect the debtor's future potential, the valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code's principle of providing a breathing spell from business adversity.
- Accordingly, except in small and medium-sized enterprise cases, the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be. This adjustment should consider whether the class immediately junior to a senior

⁷⁶¹ In the case of a sale, the reorganization value is limited to the net value actually available for distributions to creditors after any applicable reductions, expenses, or charges.

class⁷⁶² benefiting from preserving the firm's value as a going concern in connection with a chapter 11 plan or section 363x sale (the "*immediately junior class*") should receive an allocation of value to recognize that the future possibilities of the ongoing firm include the possibility that such an immediately junior class might have been in the money or received a greater recovery if the firm had been valued at a later date.⁷⁶³

- In furtherance of this principle, except in small and medium-sized enterprise cases, an immediately junior class that might otherwise be permanently cut off from receiving value based on the reorganization value as of the effective date of the plan or the date of the section 363x sale order should be entitled to an allocation of value referred to as the "redemption option value" attributable to such class, as defined below. A distribution of redemption option value, if any, would be made to an immediately junior class to reflect the possibility that, between the plan effective date or sale order date and the third anniversary of the petition date (the "*redemption period*"), the value of the firm might have been sufficient to pay the senior class in full with interest and provide incremental value to such immediately junior class.⁷⁶⁴ As explained below, the redemption option value in any given case may be negligible or non-existent; it is not a percentage or fixed payment to junior creditors.
- In accordance with the above general principles, section 1129(b) should be amended to provide that, subject to the conditions described below,
 - (a) a chapter 11 plan may be confirmed over the non-acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, attributable to such class, and
 - (b) a chapter 11 plan may be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule

⁷⁶² For purposes of applying these principles in connection with a chapter 11 plan when there is no sale of the firm, the relevant senior stakeholders are the class or classes of senior creditors receiving the residual interests (e.g., equity securities) in the firm that will benefit from the firm's appreciation after the effective date of the plan. Generally speaking, outside the sale context (whether the sale is under section 363x or pursuant to a plan), a senior class paid in cash or solely in debt securities of the reorganized firm that receives no ongoing interest in the residual value (e.g., equity) of the firm would not be required to share reorganization option value, which is intended to represent an allocation of value arising from the possibility of future appreciation in the value of the reorganized firm, with a junior class. How the principles would be applied when the residual interests in the firm are allocated among several senior classes is an issue that requires further development. In the context of a sale of substantially all of the assets of the firm, whether under section 363x or pursuant to a plan, the distribution to the immediately junior class would, generally speaking, be from the senior class's or classes' otherwise-applicable entitlement to the proceeds of the sale and would be made in cash or such other consideration that allocates the redemption option value to such immediately junior class from such proceeds.

⁷⁶³ In theory, this principle should apply to the allocation of the estate's value between senior and junior classes of creditors, whether the relative priority of their claims arises from liens, contractual subordination, or otherwise.

⁷⁶⁴ Because redemption option value is determined based on the presumption that the senior class, including any unsecured deficiency claims of the senior class if the senior class holds secured claims, is paid in full, under this principle the deficiency claims held by the senior class generally would not be entitled to share in redemption option value even if such a deficiency claim would be otherwise included in the immediately junior class.

treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class.

- Notwithstanding clause (a) above, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class.
- Similarly, except in small and medium-sized enterprise cases, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class.⁷⁶⁵ If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.
- Based on these principles, even if an impaired senior class would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the section 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described above.
 - o The “*redemption option value*” attributable to such immediately junior class is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price (as defined below) and a duration equal to the redemption period (as defined above).⁷⁶⁶
 - o Generally speaking, the immediately junior class will be the class of stakeholders that would first derive material benefit from future increases in the reorganization value of the firm after payment in full of all senior classes receiving distributions under the plan. The immediately junior class

⁷⁶⁵ The Commission recognized that an individual creditor, several creditors, or the entire class could file objections to the sale. The Commission did not resolve the level of objection required, or whether an objection that was overruled by the court would preclude only that creditor's entitlement to any redemption option value.

⁷⁶⁶ Since this principle establishes a minimum recovery for the junior class where the class members have not objected to the section 363x sale, the reorganization value is fixed at the net value realized by the estate in connection with the sale. As noted below, the junior class can still dispute how the redemption option value is being calculated for such reorganization value (by presenting evidence on other components of the redemption option value calculation, such as volatility). On the other hand, if there is no section 363x sale, the junior class may contest the reorganization value under the plan, and trigger application of the absolute priority rule by rejecting the plan and in that context the junior class could assert the right to a portion of a higher reorganization value.

will typically be the class immediately junior to the fulcrum security class (*i.e.*, the most junior class in the debtor's capital structure receiving material distributions in the case and at which the firm's reorganization value is exhausted at the time of the enterprise valuation in the case). However, if under the plan the fulcrum class will receive a relatively small participation in the residual value of the firm at the current reorganization value because the bulk of such participation is allocated to other more senior classes, the fulcrum class may be the immediately junior class for these purposes.

- o Where the senior class would otherwise be entitled to the entire value of the firm, the “**redemption price**” of the hypothetical option would be the full face amount of the claims of the senior class,⁷⁶⁷ including any unsecured deficiency claim, plus any interest at the non-default contract rate⁷⁶⁸ plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option.
 - o A redemption period would be specified for purposes of setting the duration of the redemption option commencing on the effective date of the plan or the date of the section 363x sale order and ending on the third anniversary of the petition date.
- The court would determine the redemption option value, if any, attributable to the immediately junior class based on the evidence presented by the parties at the hearing under section 1129(b) or section 363x, as the case may be. The parties may, for example, demonstrate the existence, or lack, of any redemption option value through generally accepted market-based valuation models, including the Black-Scholes option pricing model, using reasonable assumptions based on the facts of the particular case.
 - The redemption option value could be paid pursuant to the plan or section 363x sale order in the form of cash, debt, stock, warrants, or other consideration, provided that any non-cash consideration would be valued on a basis consistent with the manner in which reorganization value was determined. The form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value, regardless of whether such senior class has accepted the plan.
 - The value distributed to the immediately junior class under these principles need not be, and in most cases likely would not be, in the form of an actual option.

⁷⁶⁷ In more complex cases, where a single senior class is not entitled to the entire reorganization value of the firm and other classes senior to the immediately junior class are receiving distributions, the redemption price would have to be adjusted to include the claims of all of such senior classes, whether or not they are receiving residual interests in the firm or are among the classes required to share reorganization option value with the immediately junior class.

⁷⁶⁸ The Commission discussed the appropriate interest rate to be used in determining the redemption option value and decided to use the non-default contract rate. Some Commissioners expressed the view that the default contract rate or a rate reflecting the risk of investing in the equity of the reorganized debtor should be used because the senior creditor is absorbing all of the downside risk inherent in such equity while sharing the upside potential.

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

- If an immediately junior class is not entitled to redemption option value for any of the reasons set forth above, such immediately junior class would be entitled to receive distributions only on a strict absolute priority basis under section 1129(b) as of the effective date of the plan, as under current law, and no special provision for redemption option value would have to be made for such class in accordance with the above principles.
- A senior creditor's election under section 1111(b) of the Bankruptcy Code should not dilute or otherwise affect the immediately junior class's rights to receive any redemption option value under the distribution rules set forth in this principle.
- The principles set forth above are not intended to alter the order of creditor priorities or to affect allocations within a particular class of creditors; rather, the principles speak generally to how courts should determine whether the reorganization value of the debtor or its assets is sufficient to support a distribution to the immediately junior class.
- The principles set forth above attempt to provide a conceptual framework for an adjustment to the current absolute priority rule, which often results in wasteful and time-consuming litigation over reorganization value in recognition that the determination of reorganization value has the effect of cutting off alternative distributional possibilities based on the fortuity of timing of the reorganization or sale. It is important to note, however, that the conceptual principle of allocating redemption option value to the immediately junior class requires further development to determine whether and how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value (for example where it is secured by only some of the assets of the firm), where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all such senior classes are receiving distributions in the form of interests in the residual value of the firm, where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full.

Creditors' Rights to Reorganization Value and Redemption Option Value: Background

The Bankruptcy Code operates, among other things, to evaluate creditors' rights based, in part, on their state law entitlements and priorities. Commentators and practitioners frequently debate exactly what state law entitlements and priorities mean in the context of secured creditors. Exactly which secured creditors' rights can be modified? Are any of those rights inviolate? A variety of factors affect

this analysis, including the secured creditors' rights under state law and the Fifth Amendment of the U.S. Constitution, and Congress's ability to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States" under the Bankruptcy Clause of the U.S. Constitution.⁷⁶⁹

The Fifth Amendment provides in relevant part: "No person shall be . . . deprived of life, liberty, or property, without due process of law."⁷⁷⁰ Justice William O. Douglas notably explained that in bankruptcy, "[s]afeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that."⁷⁷¹ Commentators and practitioners have interpreted Justice Douglas's explanation in a variety of ways, with some suggesting that it means that a secured creditor is only entitled to the liquidation value of its interest in the debtor's property in bankruptcy, and others suggesting a broader meaning. Still another perspective is articulated by Prof. Tabb, who concludes that "a Fifth Amendment takings analysis simply is not helpful or indeed even applicable when considering the nature and scope of the protection constitutionally due to secured creditors in bankruptcy."⁷⁷²

The value of a secured creditor's interest in the debtor's interest in property is relevant at various points in the chapter 11 case. As explained above in the context of adequate protection, section 506(a) provides in relevant part that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."⁷⁷³ The valuation of a secured creditor's claim thus involves at least two questions, both of which can provoke litigation: What is the appropriate valuation standard for the property included in the secured creditor's collateral, and what is the appropriate standard for determining the value of the secured creditor's interest in such collateral under that standard? It also can raise a third issue concerning the appropriate valuation methodology — *e.g.*, discounted cash flow, precedent sale transactions, and comparable company analysis.

Courts have taken different approaches to questions of valuation in chapter 11. Some courts suggest that liquidation value is always an appropriate standard for determining the value of the secured creditor's interest in collateral because the debtor is operating in bankruptcy. Other courts apply a liquidation standard when valuing claims in chapter 7, and a going concern standard in reorganizations under chapter 11 on the theory that the valuation should be based on how the collateral is being used. Still other courts struggle with whether a liquidation standard, if appropriate, should be analyzed on a forced-sale or orderly-sale basis. The uncertainty surrounding valuation issues generates both litigation and, arguably, consensual resolutions.

In the plan context, chapter 11 encourages consensual resolutions and permits parties to agree to distributions under a chapter 11 plan that may modify or otherwise affect their rights against the estate. Sections 1126 and 1129 codify this concept by providing that if the debtor proposes to impair the rights of a class of creditors or interest-holders under the plan and that impaired class accepts

⁷⁶⁹ U.S. Const. art. I, § 8, cl. 4.

⁷⁷⁰ *Id.* amend. V.

⁷⁷¹ *Wright v. Union Cent. Life Ins. Co.*, 311 U.S. 273, 278 (1940).

⁷⁷² Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *1 (arguing that the "Fifth Amendment Takings Clause does not and should not constrain the power of Congress to modify the substantive rights of secured creditors under the Bankruptcy Clause").

⁷⁷³ 11 U.S.C. § 506(a).

the plan, the proposed treatment of the claims or interests is permissible even if it provides those creditors or interest-holders with arguably less than otherwise required.⁷⁷⁴ If an impaired class of claim- or interest-holders, however, does not accept the plan, the debtor can impose the proposed treatment on the class only if the plan satisfies the cramdown provisions of section 1129(b) of the Bankruptcy Code, including the absolute priority rule.⁷⁷⁵

The absolute priority rule as applied under Section 1129(b) in essence provides that a dissenting class of creditors must be paid in full before junior creditors or interest-holders may receive any distributions under the plan. The rule originates from the railroad equity receivership cases in the early 1900s and the U.S. Supreme Court's decision in *Northern Pacific Railway Co. v. Boyd*.⁷⁷⁶ In that case, the railroad company reorganized by selling itself to bondholders and equity security holders and providing no distributions to junior creditors. The Supreme Court rejected this scheme and held that "[i]f the value of the [rail]road justified the issuance of stock exchanged for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control."⁷⁷⁷

The absolute priority rule codified in section 1129(b) is a variation of the rule announced by the Supreme Court in *Boyd*, but it continues the basic tenet that priority matters — *i.e.*, secured creditors have a right to receive payment in full prior to junior creditors and interest-holders receiving any value. Section 1129(b) also articulates an application of the absolute priority rule for secured claims, which preserves those payment rights in the waterfall payment scheme of a chapter 11 plan. As one commentator noted shortly after the enactment of the Bankruptcy Code, "the [absolute priority] test for secured claims is completely novel, affording protection for classes of secured claims that is not provided under present law."⁷⁷⁸

The absolute priority rule is an important creditor protection in chapter 11 cases, but it also has proven to be inflexible and often a barrier to a debtor's successful reorganization. It also can allocate value among creditors in an arguably random manner depending on the timing of the value realization event — *i.e.*, plan confirmation. For example, to the extent that a plan is confirmed during a downturn in the economy generally or the debtor's industry more specifically, the valuations used to support the plan distributions may value the reorganized entity at a low point in the valuation cycle. Creditors may not have an appetite for, or the debtor may not have the financial ability to, continue to operate in chapter 11 until the valuation improves, or the debtor may not have the ability to offer adequate protection to secured creditors for the use of cash collateral or to obtain DIP financing, which may limit (or allow the secured creditor to limit) the duration of the case. Accordingly, under the absolute priority rule, junior creditors and interest-holders may lose their rights against the estate and receive no value on account of their claims simply because of the timing of the valuation of the enterprise in the chapter 11 case, while secured creditors, whose rights outside of bankruptcy

⁷⁷⁴ *Id.* §§ 1126, 1129(a).

⁷⁷⁵ *Id.* § 1129(a), (b). For a discussion of the "no unfair discrimination" requirement of section 1129(b), see Section VI.B, *Approval of Section 363x Sales*.

⁷⁷⁶ *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

⁷⁷⁷ *Id.* at 507–08. See also *Ecker v. W. Pac. R.R. Corp.*, 318 U.S. 448 (1943); *Marine Harbor Props., Inc. v. Mfrs. Trust Co.*, 317 U.S. 78 (1942); *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 520 (1941); *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 122 (1939) (noting that *Boyd* adopts an absolute priority rule).

⁷⁷⁸ Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, *supra* note 759, at 143 (citations omitted).

would have been limited to foreclosure, get the benefits of the chapter 11 case and the exclusive right to the future possibilities of the firm as a reorganized going concern.

Notably, similar valuation and distribution issues may arise in the context of a sale of all or substantially all of a debtor's assets under section 363(b) and proposed section 363x under these principles. Although the price being offered for a debtor's assets in a section 363 sale arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale, or economic or industry factors are negatively impacting valuations, the debtor's estate may be monetized at value far below what the estate could be worth at a later date to the prejudice of stakeholders lower in the pecking order of priorities. The arguable unfairness of this result is potentially intensified when the secured creditor is the purchaser of the assets, for example using a credit bid, and is able to capture the future increments in value solely for its own benefit.

Creditors' Rights to Reorganization Value and Redemption Option Value: Recommendations and Findings

Throughout their deliberations, the Commissioners held lengthy and thoughtful discussions concerning the rights of senior creditors in bankruptcy and how best to balance these rights with the reorganization needs of the debtor and the interests of other stakeholders.⁷⁷⁹ The Commissioners analyzed changes and trends in the secured lending industry and financial markets generally.⁷⁸⁰ They considered credit pricing and its relation to collateral valuations and risk assessments.⁷⁸¹ And they reviewed the literature representing all sides of these issues, including the commentary and studies on the perceived increase in senior creditor control in chapter 11 cases.⁷⁸²

⁷⁷⁹ See *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the importance of secured creditors' rights and the need for certainty for the capital markets when debtors are in bankruptcy), available at Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), available at Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (stating that secured creditors need certainty that their prepetition contractual agreements will be upheld in bankruptcy and that significant changes to this certainty will cause the cost of credit to increase), available at Commission website, *supra* note 55.

⁷⁸⁰ See, e.g., *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Oct. 17, 2012) ("The primary leveraged loan market has grown dramatically in the last 10 to 15 years."), available at Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("Secured lending is a critical part of the capital markets, particularly for non-investment-grade borrowers. Indeed, virtually 100% of leveraged loans are secured, and secured debt makes up 50% of the leveraged finance market as a whole."), available at Commission website, *supra* note 55.

⁷⁸¹ See, e.g., *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 7 (Oct. 17, 2012) ("Senior secured loans sit atop the capital structure of corporations — situated above high yield bonds, convertible securities, preferred stock, and common stock — and offer corporate America a private and cheaper source of funding than would otherwise be available. Because of the senior secured nature of leveraged loans, and the protections afforded to secured lenders, investors are willing to accept a far lower yield on their investment. For example, over the last three years, leveraged B-rated loans have been priced in the primary market — that is, they yield — approximately 200 basis points less than B-rated unsecured bonds, with this substantial savings (25%) passing directly to the borrower."), available at Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("By providing collateral for a loan, borrowers have the option of providing their lenders with a lower-risk basis on which to extend credit, in exchange for which the borrower obtains capital at a lower price. Indeed, non-investment-grade borrowers essentially have no access to the unsecured loan market, and absent secured loans, would be forced to issue high-yield bonds or risk being shut out of access to the capital markets altogether. Borrowing on an unsecured basis at extraordinarily punitive interest rates — or being denied credit altogether — may do far more harm to a company than borrowing at more reasonable rates on a secured basis."), available at Commission website, *supra* note 55.

⁷⁸² *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (June 4, 2013) (noting that the adequate protection rules are increasingly resulting in retailer liquidation because substantially all of a distressed retailer's assets are subject to prepetition liens and because of the adequate protection provision, debtors may not use or sell their assets without the lender's consent; and lenders are not consenting), available at Commission website, *supra* note 55. See generally Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 523 (2009); Barry E. Adler, *Bankruptcy Primitives*, 12 Am. Bankr. Inst. L. Rev. 219, 239 (2004) ("Chapter 11 is not for every firm, and the Bankruptcy Code should not permit chapter 11 to be an option for a debtor with a

As discussed more fully in the context of adequate protection above, the Commissioners recognized the competing interests at stake and that the extreme position on either the pro-senior creditor or the pro-residual stakeholder side was not in the best interests of chapter 11 or the bankruptcy system. They strived to reach an appropriate balancing of these interests to the greatest extent possible. That balancing provides for valuing a senior creditor's collateral at (i) foreclosure value (as defined in these principles) for purposes of adequate protection, and (ii) reorganization value (as defined in these principles) for purposes of distributions in the case. The Commissioners believed that this balance would enhance a debtor's ability to obtain much-needed liquidity early in the case while allowing the senior creditor to benefit from the reorganized debtor's continued use of collateral in the ongoing business by receiving the value of its collateral on an enterprise or going concern basis later in the case. They also found that it comported with the mandate of section 506(a) that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."⁷⁸³

The definition of reorganization value in these principles is designed to capture the total enterprise value of the firm, including value generated through the chapter 11 case. Subject to the principles regarding redemption option value described below and the courts' powers under sections 506(c) and 552(b), as described in Section VI.C.3, *Section 506(c) and Charges Against Collateral* and Section VI.C.4, *Section 552(b) and Equities of the Case*, the principles further provide that a senior creditor should be entitled to receive the reorganization value of its collateral under a chapter 11 plan or in a section 363x sale.

The Commission received substantial testimony on the allocation of value in chapter 11 cases. Several witnesses posited that chapter 11 cases were being run for the benefit of the senior creditors and generating little, if any, value for other creditors.⁷⁸⁴ Commentators have also observed this trend.⁷⁸⁵

corporate charter that provides an alternative process in the event of default."); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1211 (2006) (discussing increased role of creditors in chapter 11 process); David A. Skeel, *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917, 918 (2003) ("Whereas the debtor and its managers seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast."). But see Westbrook, *The Role of Secured Credit in Chapter 11 Cases*, *supra* note 750, at *1 (forthcoming 2015) (stating that "secured creditor control is less pervasive than has been asserted").

⁷⁸³ 11 U.S.C. § 506(a).

⁷⁸⁴ See, e.g., *Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Oct. 26, 2012) (NCBJ Transcript) ("I think what you've got today is that because of the move from being unsecured creditor status to secured creditor status, which is happened over the last number of years that I've been in the business, it's increased the leverage of the secured creditors and thus reduced the flexibility of a rehabilitation during this process."), available at Commission website, *supra* note 55; *Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) ("Over the years the secured lenders have increased their control over the company during the pre-petition period by taking dominion of the cash via lockbox sweeps; and requiring strict budgets and forbearance agreements. These actions enable the secured creditor to significantly increase their control over borrower cash and ultimately over a Chapter 11 filing should the borrower choose to go that route."), available at Commission website, *supra* note 55; *Written Statement of Jim Millstein, Chairman of Millstein & Co.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Apr. 19, 2012) ("[B]y virtue of the significant protections afforded secured debt under Chapter 11, sophisticated creditors take pains to structure their credit extensions in secured form when lending to companies in distress. As a result, in cases where the aggregate amount of secured debt exceeds the going concern value of the enterprise, a Chapter 11 reorganization has become little more than a court-supervised assignment for the benefit of creditors."), available at Commission website, *supra* note 55; *Written Statement of Clifford J. White, Director, Executive Office for the U.S. Trustees: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2012) (describing how DIP lending conditions often ultimately control the fate of the debtor), available at Commission website, *supra* note 55; *Oral Testimony Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Oct. 17, 2012) (LSTA Transcript) (noting that secured creditors have great influence over DIP lending terms), available at Commission website, *supra* note 55. See also Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *3–4 ("One of the most notable developments in chapter 11 reorganization practice in this millennium is the dramatic expansion in the power exercised by secured creditors. Financing has experienced a sea change, and today many firms enter chapter 11 with their assets full (or almost fully) encumbered. The reality then is that the entire reorganization is dependent on the good graces of the prebankruptcy controlling secured lender. That means that important stakeholders — bondholders, trade creditors, tort victims, employees, and shareholders, to name but a few — are excluded from any recovery but for the whims of the controlling secured creditor.").

⁷⁸⁵ See, e.g., Jacoby & Janger, *Ice Cube Bonds*, *supra* note 283, at 922–23 (discussing lender control exerted over timing of sales through postpetition financing and blanket liens); Anthony J. Casey, *The Creditor's Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759, 760 (2011) ("A secured creditor, exercising control over the debtor firm, determines that

Similarly, witnesses expressed concerns regarding the lack of a debtor's equity in its property at the commencement of its case and the challenges presented to restructuring the debtor under these circumstances.⁷⁸⁶ The Commission also heard testimony concerning how the timing of a chapter 11 case — and the value realization event in the case (e.g., plan confirmation or sale approval) — can impact value allocations among creditors, and also how capital structures overwhelmed by secured debt and a resulting difficulty in obtaining postpetition financing to continue operations are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales.⁷⁸⁷

The Commissioners debated both the underlying premises in this testimony, as well as possible ways to address the concerns.⁷⁸⁸ The Commissioners noted the increasing concerns among commentators and practitioners regarding administratively insolvent chapter 11 cases, structured dismissals, and issues regarding value allocation in chapter 11 cases.⁷⁸⁹ They observed that in the recent cycle of chapter 11 cases, the fulcrum security (i.e., the priority level of the class of debt in the debtor's capital

a bankruptcy filing to facilitate such a sale is the optimal strategy for the distressed firm. The debtor then files, and the sale is accomplished").

786 See *Written Testimony of Michael R. ("Buzz") Rochelle: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 22, 2013) ("Today the newly-filed debtor is already under water; the secured lender is under-secured; and use of cash collateral generally comes with concessions that tighten security documentation and tie the debtor to a short-term budget which allows for little but locating an asset purchaser."), available at Commission website, *supra* note 55; *Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3, 4–5, 6 (Nov. 3, 2012) (stating that secured creditors have often "liened up" all the debtor's assets prior to the bankruptcy, hurting the debtor's chance at rehabilitation), available at Commission website, *supra* note 55. "Lenders providing postpetition financing no longer do so in order to make good returns with assured repayment, or protect their prepetition positions by getting collateral for previously unsecured loans. Instead, they often do so in order to take control of the debtor, through covenants, deadlines, and default provisions." *Id.*

787 See, e.g., *Written Statement of Professor Anthony J. Casey: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 7, 2013) ("On the other hand, the secured creditor may exercise its foreclosure and liquidation rights when the debtor defaults. But that liquidation cuts off the future of the assets as part of a going concern. Thus, the secured creditor's claim on going concern is extinguished along with the junior creditors' claims. The secured creditor essentially has two options: take the liquidation value or keep the firm alive subject to the junior creditors' claims."), available at Commission website, *supra* note 55; *Written Statement of Sandra E. Horowitz: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Feb. 21, 2013) ("Finally, a third challenge confronting creditors' committees is the growing use of quick Section 363 asset sales, a situation that can undermine their efforts to maximize recoveries for general unsecured creditors. While I recognize that a sale can be viewed as the real value of the estate and the only viable option, I would argue that this alternative can benefit the DIP lenders and possibly other secured creditors to the complete detriment of the unsecured credits who may well benefit from a classical operational and financial restructuring from which value can ultimately be realized."), available at Commission website, *supra* note 55.

788 Notably, the Commission also received and considered at length testimony on the value of secured credit in bankruptcy and the important role markets play in providing liquidity to distressed companies. See, e.g., *Oral Testimony of Elliot Ganz: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("There are two things that are especially important to the smooth functioning of the market, legal clarity and financial liquidity. First, lenders and investors need to know what the rules are prior to entering into a transaction. They need to have the confidence that the rights they've bargained for will be respected and enforced. Second, they need to know that they have the ability to sell their positions, especially when things go south."), available at Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Oct. 17, 2012) ("Secured credit is also vital when the capital markets constrict, as they did just a few years ago in the aftermath of the 2008 financial crisis. At that time, when leveraged markets were barely functioning, investors were extraordinarily (and understandably) careful about investing in non-investment-grade debt. At the same time, due to the economic downturn, many companies were facing challenges to their businesses and needed capital just as the markets were freezing up. For a very large number of those companies, the solution was to access the secured debt markets."), available at Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[L]essening the protections accorded secured creditors would affect loan sizes going forward. Lenders would not be willing to lend as much if they cannot be sure that they will be able to collect as much as they are owed or the value of their collateral in the event of default."), available at Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 15, 2012) ("Asset-based financing extended by CFA members has played an important role in financing the growth of U.S. companies for many decades. It allows companies the opportunity to obtain the working capital they need to operate and grow, and create jobs, and also provides financing for capital expenditures and the acquisition of other companies."), available at Commission website, *supra* note 55. Throughout deliberations — on all issues — the Commission worked to balance competing interests and perspectives.

789 See, e.g., Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, Am. Bankr. Inst. J., Mar. 2011, at 20; Bruce S. Nathan & Bruce D. Buechler, *Who Pays the Freight? Interplay Between Priority Claims and a Debtor's Secured Lender*, Am. Bankr. Inst. J., Nov. 2011, at 26; Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative after Asset Sales*, Am. Bankr. Inst. J., June 2010, at 1; Charles R. Sterbach & Kerian M. Atencio, *Why Johnny Can't Get Paid on His General Unsecured Claims: a Potpourri of Lingering Abuses in Chapter 11 Cases*, 14 J. Bankr. L. & Prac. 1, Art. 3 (2005).

structure at which the firm's enterprise value is exhausted at the time of the enterprise valuation in the case) was higher in the debtor's capital structure than in the past. Although in 1978 the fulcrum security was almost always general unsecured claims, in more recent cycles, the fulcrum security was increasingly often at the senior creditor or subordinated senior creditor level.⁷⁹⁰

The Commissioners discussed the potential reasons for this trend, including the testimony from the lending community on these issues.⁷⁹¹ They acknowledged the potential role of various confounding factors such as economic cycles, lending practices, delay in commencing chapter 11 cases (which can be facilitated by the economic cycle and the availability of cheap money, as well as a management's resistance to a filing), outdated or underperforming business models, ineffective management, and other market or constituent pressures. They also recognized and discussed the arguments of commentators and practitioners who believe that value allocation and creditors' recoveries should remain relatively unchanged and are appropriate given parties' state law rights.⁷⁹² The Commission

⁷⁹⁰ See, e.g., *Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 22 (Oct. 26, 2012) (NCBJ Transcript) ("If you just looked at the Lehman example, you see that at the 11th hour, various sophisticated creditors went from unsecured status to secured status and, in fact, used the safe harbors to the tune of \$17 billion. The answer is more sophisticated the creditor, in this case, would be your banker. Your banker has an opportunity to take advantage of all other classes of creditors by moving effectively from unsecured status to secured status. That's happened in Lehman, and it happens every day."), available at Commission website, *supra* note 55; *Written Statement of Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 15, 2012) ("In the middle market cases, it is the secured debt that is the fulcrum credit."), available at Commission website, *supra* note 55. See also Christie Smythe, "Fulcrum" Deals Rising to Prominence, Experts Say, *Law 360* (Oct. 9, 2009, 1:26 PM) ("While in the past fulcrum securities were generally unsecured bonds, secured bonds have also become fulcrum securities in some recent bankruptcy scenarios as a result of the lending practices before the credit crisis, experts said."), available at <http://www.law360.com/articles/122360/fulcrum-deals-rising-to-prominence-experts-say>.

⁷⁹¹ See, e.g., *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 10 (Oct. 17, 2012) ("During the financial crisis of 2008-2009, primary markets for both leveraged loans and high yield unsecured bonds seized up (illustrated on Slide 6). Importantly, the senior secured high yield bond market increased dramatically to take up some of the slack, providing crucial liquidity that was otherwise unavailable. In 2007, leveraged lending volume plunged from \$535 billion to \$152 billion and \$76 in 2008 and 2009, respectively. Similarly, unsecured high yield bond volume fell from \$143 billion in 2007 to \$68 billion in 2008, before recovering to \$163 billion in 2009. Despite the precipitous decline in leveraged loans and unsecured high yield bonds, secured high yield bond volume moved to fill the void in 2009, with issuance of \$60 billion, a ten-fold increase from 2008, and a four-fold increase from 2007, when respective volume was \$6 billion and \$15 billion."), available at Commission website, *supra* note 55; *Oral Testimony of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 28 (Oct. 17, 2012) (transcript) ("What I would say is, we've definitely seen an increase in percentages of debt raised in the high-yield bond that's secured, so you're probably talking about 25% of the high-yield bond market having any kind of security around it back in '06. Today you're in the low 30s, and we peaked about 34-35% number, so it definitely picked up by about 10% during that period of time, and it was noticeable because the debt overall in the bond market was down then, so it felt like there were so many bond issuers in there, and there were because that was how you raised capital. . . . I would say that the other side of that equation was there was no loans being issued for the most part, so the secured bonds in no way filled the hole that was left behind by the loans that were not being raised. The loan market has been recovering pretty steadily, more or less, for the last three years now, but I don't know that we are back to where we were in that Golden Day of the CLO."), available at Commission website, *supra* note 55.

⁷⁹² See, e.g., *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Oct. 17, 2012) ("Since bank loans are typically the most senior debt in a company's capital structure, and generally have first lien claim to a company's assets in the event of bankruptcy, they fare far better upon default than other indebtedness. Moreover, that level of recovery has stayed remarkably consistent over the last four credit cycles. According to an analysis by Moody's Investor Services, which tracked more than 1,000 corporate defaults since January 1987, average recoveries for bank loans were approximately 80 cents on the dollar, compared with recovery of less than 50 cents on the dollar for senior unsecured bonds and 30 cents on the dollar for subordinated bonds."), available at Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[F]ocusing only on the debtors that fail to reorganize in chapter 11 ignores the far greater number of companies who avoid bankruptcy entirely, and instead develop their businesses and create jobs, because they are able to access low-cost, secured credit. The ability to pledge collateral is particularly vital to both healthy non-investment-grade and financially distressed companies. In both cases, the security interest is a critical tool in reducing the cost of credit, and in many cases is a necessary condition to the extension of credit at all. Without the ability to offer an enforceable security interest, non-investment-grade borrowers may lack sufficient access to the capital markets."), available at Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("[B]ankruptcy reforms will not affect bankruptcy alone. Weakening the protections available to secured creditors, or reducing the recovery of holders of debt bought on the secondary market, will have a profound, and negative, effect on the availability and price of credit — particularly credit extended to non-investment-grade companies."), available at Commission website, *supra* note 55; *Oral Testimony of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Oct. 17, 2012) (transcript) ("If you look at capital structures 10 years back and the ratios of senior secured debt to subordinated debt I would suspect that, in general, that those capital structures are not dramatically different."), available at Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the*

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ultimately concluded that trying to isolate the cause was futile and that a better approach would be to explore ways to enhance the value allocation rules and distribution mechanisms in chapter 11 so as to continue to protect the rights of senior creditors, protect junior creditors against being cut off entirely from the future possibilities of the firm based on a valuation at a single moment in time and based on other factors that may be outside of the debtor's control, and incentivize the major parties to reach a consensual reorganization if the underlying economics justified the debtor's emergence as an ongoing enterprise.

The Commissioners worked extensively to identify ways to achieve these goals. The Commission generally agreed that the timing of a judicially supervised reorganization in the life cycle of the credit markets generally and in the business life cycle of a given company should not dictate hard and fast distributional rules that advantage the creditors who happen to be in the senior position at a given moment in time. The Commissioners discussed this basic premise at length and the concept that a valuation date set by the effective date of a plan or the date of a section 363x sale order should not cut off all future possibilities associated with the affected assets for a junior class that appears to be significantly impaired or out of the money on the plan or sale valuation date. Accordingly, the Commission determined to recommend the following overarching principle: the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be, which would enable junior creditors to “redeem” in full the allowed claim of the impaired senior creditors receiving the reorganization value of the company under such plan or sale.

Under this principle, even if an impaired class of senior creditors would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described in the principles above.⁷⁹³ Specifically, a chapter 11 plan may be confirmed (a) over the non-acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, applicable to such class, and (b) over the non-acceptance of a

Reform of Chapter 11, at 3 (Nov. 15, 2012) (“If the Commission ultimately proposes reducing the rights of secured lenders in Chapter 11, then it is our organization's view that anything short of allowing secured lenders the ability to obtain the benefits provided under their pre-chapter 11 loan agreements in Chapter 11 will have the direct effect of increasing our members' risk analysis which will result in increasing the cost of credit and reducing the amount of credit extended to SME borrowers who seek relief under Chapter 11.”), available at Commission website, *supra* note 55.

793 For a thoughtful analysis of “option” value in chapter 11 cases, see Casey, *supra* note 785 (explaining value distortions created by the creditors' bargain and strict adherence to the absolute priority rule, and proposing a creditors' call option to address such valuation distortions). See also Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1936 (2006) (“The presence of valuation uncertainty can, by itself, give option value to the claims of junior creditors even when they are, in expectation, out of the money.”) It should be noted that Professor Casey talks about preserving secured creditors' nonbankruptcy foreclosure value. See Casey, *supra* note 785, at 789 (“The creditors'-bargain model requires a distributional rule that — while respecting nonbankruptcy contract rights — maximizes the aggregate pool of assets in bankruptcy. This means protecting the secured creditor's right to nonbankruptcy foreclosure value and the unsecured creditor's call option, while allocating bankruptcy rights in a way that creates the optimal incentives for the creditors. The proposed Option-Preservation Priority does precisely that.”). The Commissioners debated the “foreclosure” vs. “reorganization” value issue at length and the Commission determined that, as part of the overall compromise reached in the principles, if a plan is confirmed or a sale is approved, secured creditors should be permitted to receive the reorganization value of their collateral, which could be greater than the nonbankruptcy foreclosure value.

senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class. Notwithstanding the foregoing, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class. Similarly, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class. If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.

The Commission agreed that the principles governing redemption option value in chapter 11 cases should not apply to cases involving small and medium-sized enterprises. The Commission believed that further study and development of the principles would be needed to determine whether they could be applied in a cost-effective and meaningful manner in such cases. The Commission proposed separate principles governing confirmation of chapter 11 plans in small and medium-sized enterprise cases, in Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

In developing these principles, the Commissioners discussed, debated, and refined several key concepts necessary to determine whether distributions to stakeholders should be adjusted due to the possibility of changes of the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be. The Commission concluded that the redemption option value attributable to the immediately junior class should be the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period. Notably, value distributed to the immediately junior class under these principles need not be, and in most cases likely would not be, in the form of an actual option. The requirement is that the requisite *value* be distributed to the immediately junior class, regardless of form.

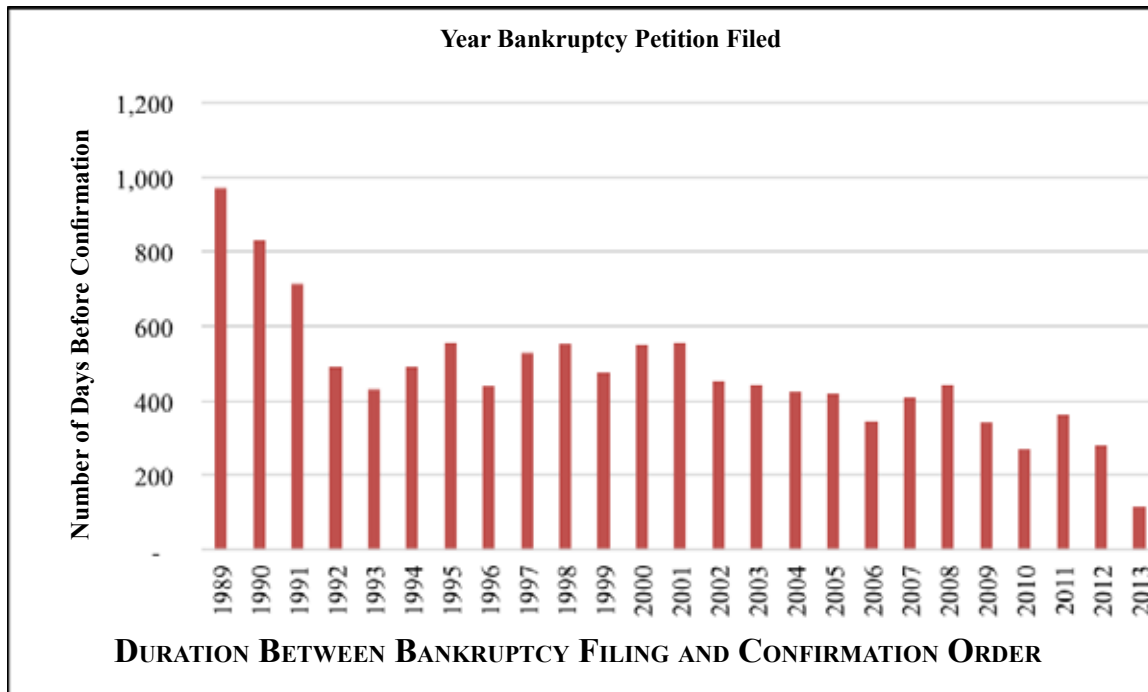
Although a relatively straightforward concept in a simple capital structure (see example below), the Commissioners recognized the potential complexities of applying these principles in more involved corporate and financing structures. Accordingly, the Commissioners strived to identify principles that define the basic parameters of junior creditors' rights, with the expectation that there would be further development of the appropriate mechanisms for applying the principles in more complex cases. Indeed, the principles set forth above are not intended to alter the order of creditor priorities or to affect allocations within a particular class of creditors; rather, the principles speak generally to how courts should determine whether the value of the debtor or its assets is sufficient to support a distribution to the immediately junior class. The Commissioners acknowledged that, in implementing the redemption option value concept, the mechanism invoked by the parties and the

courts will likely require further development to determine whether and how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value (for example where it is secured by only some of the assets of the firm), where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all senior classes are receiving distributions in the form of interests in the residual value of the firm, where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full.

In their discussions of redemption option value, the Commissioners methodically examined various formulas and procedures for addressing the potential deficiencies in chapter 11 valuations based on the timing of the effective date of the plan or the date of the section 363x sale order. For example, in a simple capital structure, the Commissioners considered the following factors and steps appropriate, and they are set forth here solely for purposes of illustration:

- *First*, the Commissioners analyzed the problem at hand — *e.g.*, timing can cause the value realization event to allocate value among creditors at a historically low valuation. The Commissioners examined the economic and financial literature and determined that most economic cycles, industry events, operational issues, etc. resolve themselves in approximately three to five years. Recognizing the need for parties to have certainty as soon as possible in the distribution context and despite strong arguments from some Commissioners for five years, the Commission decided to recommend using, as the expiration date of the exercise period for the hypothetical redemption option, a date that is three years from the petition date. Based on several factors, including the factors discussed above and the average duration of chapter 11 cases as shown in the chart below, the Commission found that determining **redemption option value** based on a hypothetical option expiring at the end of such a three year period (the **redemption period**) should be sufficient to redress the potential unfairness of permanently crystalizing the value of the firm as of a single plan confirmation date or sale date.⁷⁹⁴

⁷⁹⁴ Mr. Shrestha prepared this chart for the Commission based on data from the New Generation's Public and Major Private Companies Database. Accordingly, it was limited to public and large private companies. The duration above is from the petition date to the date of the confirmation order. In recent years, the mean and median durations for chapter 11 reorganizations (from petition date to confirmation) are respectively: 2009 (342, 275); 2010 (269, 206); 2011 (360, 338); 2012 (281, 274); 2013 (116, 108). See generally *supra* note 65 and accompanying text (generally discussing limitation of chapter 11 empirical studies).



- *Second*, the Commissioners evaluated different ways to calculate the redemption option value — *i.e.*, the potential value allocation to the immediately junior class at the time of the value realization event. After much debate, including discussion of concerns of some of the Commissioners that an option valuation methodology was not a good fit for the redemption concept, the Commission concluded that using a market-based method such as the Black-Scholes model purely as a working formula would likely be the best way to consistently and accurately determine the value of the hypothetical redemption option. Traditionally, a Black-Scholes model uses four factors to value an option: the strike price of an option, the term of the option, volatility, and the risk-free rate. In the context of calculating any **redemption option value**, (i) the strike price is 100 percent of the **redemption price** described above (*i.e.*, senior class or classes must be repaid in full before any redemption option value exists), (ii) the term of the option would expire three years from the petition date (*i.e.*, the **redemption period**); (iii) volatility could vary but can be determined for a particular debtor by looking at the historical volatility of comparable companies, using an agreed upon volatility rate, or using a set metric like the average 60 day forward volatility of the S&P 500 Index for the past four years (*i.e.*, approximately 15% at the time of this Report); and (iv) the risk-free rate generally is based on the U.S. Treasury rate.⁷⁹⁵
- *Third*, the Commissioners tested the rule using the agreed upon calculation formula under a variety of scenarios. For example, if the senior class is entitled to the entire value of the firm and is determined to be receiving 50 percent of the principal amount of their

⁷⁹⁵ The Black-Scholes formula or similar methodologies could identify the redemption option value once these four factors are identified and the percentage recovery of the secured creditors based on the reorganization value of the firm is determined as of the plan confirmation or section 363x sale order date. The Binomial Options Pricing Model, Monte Carlo options models, and other formulas may have to be considered where Black-Scholes is not effective to value an option on a particular enterprise.

again the initial percentage recovery for the senior class greatly influences the calculation). Volatility and the risk-free rate can also impact the calculation, but likely less so than the other two factors in the redemption option value context. Moreover, as indicated in the principles, the class entitled to receive the redemption option value generally will be the class immediately junior to the fulcrum security class, assuming that the fulcrum security class is the principal beneficiary of the residual value of the firm under the plan.

- *Note:* Redemption option value only exists if the senior class would receive the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option (*i.e.*, the redemption price). If any redemption option value exists under the foregoing calculation as of the plan effective date or section 363x sale order date, it could be paid pursuant to the plan or section 363x sale order in the form of cash, debt, stock, warrants, or other consideration, provided that any non-cash consideration would be valued on a basis consistent with the manner in which reorganization value was determined. The form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value, regardless of whether such senior class has accepted the plan. If no redemption option value exists on that date (or such class is not otherwise entitled to receive any redemption option value under these principles), nothing further is required and no value is distributed to such junior creditors in the case.

As explained above, the Commission recommended the addition of the redemption option value rule to the general priority scheme of the Bankruptcy Code as a minimum entitlement for the immediately junior class based on the reorganization value of the firm as of the plan effective date or section 363x sale order date. The Commissioners believed that adding the redemption option value rule would appropriately balance the competing issues at stake in the context of value realization events in a case while respecting the value of the senior creditors' interest in the debtor's property.⁷⁹⁶

As suggested by the principles, the redemption option value rule would apply in both the chapter 11 plan and section 363x sale process.⁷⁹⁷ The Commissioners discussed the potential challenges to

⁷⁹⁶ Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *5 ("Outside of bankruptcy, the secured lender may have considerable difficulty capturing anything above liquidation value. If the bankruptcy process itself allows the recovery of more value, why should all of that bankruptcy-enabled excess go to the secured lender?").

⁷⁹⁷ For a thoughtful discussion of potential value distortion in chapter 11 sales, see Jacoby & Janger, *supra* note 283, at 894–95 ("This going-concern premium is a product of the federal bankruptcy regime. Sometimes, the going-concern premium can only be obtained by acting quickly. Thus, a Bankruptcy Code created speed premium exists (as part of the going-concern premium) when a quick sale is necessary to preserve value. While both premia are worth preserving, we are concerned that parties not be able to exploit the perceived need for speed to distort the Code's distributional scheme."). In addition, Professor Casey explains such potential value distortion as follows:

Indeed, a recent study by Kenneth Ayotte and Edward Morrison shows that the outcomes of these sales are distorted by conflict between junior and senior creditors. This conflict stems from the mismatched incentives of the different classes of creditors. On the one hand, senior creditors have an incentive to sell the company in a quick sale even when reorganization has a higher expected return for the estate. Thus, when senior creditors are exercising control — which they do in most cases — the result is an inefficient fire sale of the debtor's assets. On the other hand, junior creditors have an incentive to block the quick sale in favor of a drawn-out reorganization even when the sale has the higher expected return for the estate. Thus, in cases where the junior creditors can obtain some control — usually by prevailing on procedural objections — there may be a distortion in favor of an inefficient and prolonged reorganization.

Casey, *supra* note 785, at 761–62 (citations omitted).

applying the redemption option value rule in a section 363x sale process, particularly where the purchaser is a third party and not the senior class. In those situations, the redemption option value can still be calculated based on the net purchase price and parties can determine what, if anything, must be allocated to the immediately junior class. Some of the Commissioners were concerned, however, about paying the redemption option value when the senior class was not getting the future value of the firm *per se*. Other Commissioners noted that the senior class in these situations typically receives distributions and the benefits of the section 363x sale on a quicker timeline; from that perspective, the decision to sell forecloses the plan of reorganization alternative and the future value distributions that would flow from the reorganization. The Commission agreed that the estate — and not the third party purchaser — should be responsible for paying any redemption option value to the immediately junior class. (Of course, any such value paid from the estate will reduce the value available for the senior class.) They also recognized that excluding section 363x sales to third parties from the redemption option value rule could encourage gamesmanship and alternative deal structures that avoid the rule but effectively transfer the assets or their future value to the senior class. Likewise, excluding all section 363x sales could discourage reorganizations without addressing the important issues surrounding the timing of value realization events and value allocation in chapter 11 cases discussed above.⁷⁹⁸

On balance, the Commission voted to apply the redemption option value rule to plans and all section 363x sales (except in small and medium-sized enterprise cases), recognizing that in both the plan and the sale contexts, this default rule will likely encourage consensual resolutions that benefit all. The Commission also acknowledged that the redemption option value principles set forth in this Report are essentially guidelines for courts and parties to use in developing such value allocation principles for more nuanced and complex capital structures than those vetted by the Commission. The Commission found great potential utility to the redemption value option, and it encourages the restructuring community and commentators to build upon this concept to more completely develop fair allocation rules in chapter 11 cases.

2. New Value Corollary

Recommended Principles:

- A prepetition interest-holder, including an insider, should be permitted to retain or purchase an interest in the reorganized debtor without violating the absolute priority rule of section 1129(b)(2)(B)(ii) or section 1129(b)(2)(C)(ii) of the Bankruptcy Code, if applicable, provided that such interest-holder contributes new money or money's worth to the debtor's reorganization efforts in an aggregate amount that is reasonably proportionate to the interest retained or purchased and that is subject to a reasonable market test.

⁷⁹⁸ The Commissioners discussed similar considerations in determining that a secured creditors' section 1111(b) election should not be operative under the redemption option value rule.

New Value Corollary: Background

As described in the preceding section, the absolute priority rule requires that senior classes of claims or interests be paid in full prior to junior classes receiving any distributions under the chapter 11 plan. Consequently, prepetition equity security holders generally cannot retain or receive new equity in the reorganized debtor unless all creditors are paid in full under the plan. This general rule predates the Bankruptcy Code and finds its origins in the equity receiverships of the early 1900s. As the U.S. Supreme Court explained in *Boyd*, “creditors [are] entitled to be paid before the stockholders could retain [equity] for any purpose whatever.”⁷⁹⁹

One question that arises in the context of prepetition equity security holders and the absolute priority rule is whether prepetition equity security holders can purchase equity from, or contribute new value to retain equity in, the reorganized debtor. This potential exception to the absolute priority rule is commonly called the new value exception or corollary.⁸⁰⁰ The Supreme Court provided some guidance on the new value corollary in *Bank of America National Trust and Savings Assn. v. 203 North LaSalle Street Partnership*.⁸⁰¹ In *203 North LaSalle*, the Supreme Court held: “A debtor’s pre-Bankruptcy equity security holders may not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity security holders under a plan adopted without consideration of alternatives.”⁸⁰² Although the Supreme Court acknowledged that the new value corollary might exist under some circumstances,⁸⁰³ it did not resolve the issue. Lower courts have adopted different approaches to assessing this potential exception.

Courts and commentators generally have interpreted *203 North LaSalle* as requiring a “market test” before a court confirms a chapter 11 plan in which prepetition equity security holders retain or receive equity in the reorganized entity in violation of the absolute priority rule.⁸⁰⁴ Courts do not, however, necessarily agree regarding the parameters of this market test or the minimum process required to satisfy the *203 North LaSalle* standard. In fact, some courts appear to limit the potential market tests to the two examples identified by the Supreme Court in *203 North LaSalle* — *i.e.*, a competing chapter 11 plan or competitive bidding.⁸⁰⁵

⁷⁹⁹ *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

⁸⁰⁰ Courts consider several factors in assessing the new value corollary and generally require that the purported new value be (i) new, (ii) substantial, (iii) in money or money’s worth, (iv) necessary for a successful reorganization, and (v) reasonably equivalent to the value of the stock being retained or received. *See, e.g., Bonner Mall P’ship v. U.S. Bancorp Mort. Co. (In re Bonner Mall P’ship)*, 2 F.3d 899, 908 (9th Cir. 1993), *cert. granted sub nom. U.S. Bancorp Mortg. Co. v. Bonner Mall P’ship*, 510 U.S. 1039 (1994), *motion to vacate denied and case dismissed*, 513 U.S. 18 (1994).

⁸⁰¹ *Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434 (1999).

⁸⁰² *Id.*

⁸⁰³ *See id.* (“The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary.”). *See also* Nicholas L. Georgakopoulos, *New Value After LaSalle*, 20 Bankr. Dev. J. 1, 2 (2003) (observing that the Supreme Court affirmed the new value corollary in *LaSalle*).

⁸⁰⁴ *See, e.g., In re Castleton Plaza, LP*, 707 F.3d 821 (7th Cir. 2013) (rejecting new value plan because lack of market competition prevented court from being able to test purported new value in exchange for grant of 100 percent of reorganized equity to insider in violation of absolute priority rule). *See also* Robert J. Keach, *LaSalle, The “Market Test” and Competing Plans: Still in the Fog*, Am. Bankr. Inst. J., Dec. 2002, at 18 (2002).

⁸⁰⁵ *See Bank of Am. Nat’l Trust & Sav. Ass’n v. 203 N. LaSalle St. P’ship*, 526 U.S. 434, 458 (1999) (“Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here.”). *See also In re Situation Mgmt. Sys.*, 252 B.R. 859, 861, 865 (Bankr. D. Mass. 2000) (rejecting new value plan “was not confirmable in the absence of competitive bidding for the equity interests to determine the adequacy of the new value contribution”).

New Value Corollary: Recommendations and Findings

The Commissioners discussed the new value corollary and its potential role in facilitating plans of reorganization. Several Commissioners commented on the need to provide some mechanism to allow prepetition equity security holders to retain or receive equity in the reorganized debtor. They noted that this issue was particularly relevant in cases where prepetition equity security holders included founders or other individuals whose continued association with the business was critical or valuable to the reorganized debtor. In this regard, these Commissioners believed that authorizing the new value corollary furthered the underlying reorganization goals of chapter 11.

The Commissioners also discussed instances in which prepetition equity security holders were the only, or most viable source, of funding for the chapter 11 plan. Some of the Commissioners observed that, in such cases, the requirements of the new value corollary, including the market test component, should be easily satisfied. Other Commissioners noted, however, that the uncertainty surrounding the application of the new value corollary can make this an expensive and, in some cases, impracticable process. The Commission reviewed the testimony it received on the new value corollary and the impediment it can pose to plan confirmation.⁸⁰⁶

The Commission determined that chapter 11 reorganizations would benefit from further clarity on the new value corollary. It agreed that codifying the new value corollary as an expressed exception to the absolute priority rule and identifying the key elements of the exception would enhance the confirmation process in many cases. Accordingly, the Commission recommended a statutory new value corollary that required (i) new money or money's worth; (ii) in an amount proportionate to the equity received or retained by prepetition equity security holders; and (iii) that would be subject to a "reasonable" market test. The Commission declined to define an appropriate market test; rather, it believed that courts should make this determination based on the facts, the evidence presented, and what would be reasonable in the particular case before the court.

3. Section 506(c) and Charges Against Collateral

Recommended Principles:

- The trustee should not be permitted to waive its ability to surcharge collateral, or to agree not to pursue such a surcharge, to the extent permitted under section 506(c) of the Bankruptcy Code. The surcharge under section 506(c) should continue to apply only to collateral securing prepetition debt and should not apply to new money extended solely on a postpetition basis.

⁸⁰⁶ See, e.g., *Written Statement of Maria Chavez-Ruark: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 7, 2012) (discussing inconsistencies in the application of the new value corollary). "The corollary makes sense from a policy standpoint. The underlying policy for a reorganization is rehabilitation of the business, as failed businesses lead to a loss of jobs and loss of capital, both manifestations of economic inefficiency. The new value corollary recognizes that equity holders who inject new capital into a restructured business are not gaining a position ahead of creditors because of their old equity position. Instead, they are taking a concrete step to restore the business to solvency by paying fair value for the reorganized debtor's stock." *Id.*

Section 506(c) and Charges Against Collateral: Background

Two common questions arise in the context of proceeds from property serving as collateral for a secured creditor: Can those proceeds be used to reimburse the estate for the cost of maintaining and monetizing the property, and can those proceeds be used to pay general administrative or other claims against the estate? The Bankruptcy Code addresses the first question, but it does not speak directly to the second.

Section 506(c) of the Bankruptcy Code provides: “The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all *ad valorem* property taxes with respect to the property.”⁸⁰⁷ This section protects the estate, and it allows the trustee⁸⁰⁸ to request payment for money expended on, or resources committed to, a secured creditor’s collateral.⁸⁰⁹ In addition, the trustee must establish that the expenditures were “reasonable” and “necessary” and provided a benefit to the secured creditor. The section protects a secured creditor’s collateral by incentivizing the trustee to preserve that collateral. It also protects the estate by ensuring that the secured creditor pays for this protection.⁸¹⁰

Courts have encountered several issues in applying section 506(c), including the scope of expenses included within the section and the identity of parties with standing to request payment under the section. Determining the kind of expenses that may be paid from a secured creditor’s collateral is a fact-intensive inquiry.⁸¹¹ Costs directly related to the maintenance and preservation of the collateral typically are covered.⁸¹² In addition, the trustee may be able to recover certain costs associated with operating the business if those expenditures in turn benefited the secured creditor.⁸¹³ Whether the trustee can recover its attorneys’ fees and expenses, however, is less clear. Courts scrutinize such requests closely and permit recovery in only very limited circumstances. The Third Circuit has explained that a debtor in possession’s attorneys’ fees and expenses “may be charged only against the surplus of the debtor’s estate.”⁸¹⁴

The trustee’s attorneys’ fees and expenses are only one type of administrative claim that may be incurred pending the sale of a secured creditor’s collateral. As suggested above, whether any particular administrative claim is within the scope of section 506(c) turns on whether the expenditure was

⁸⁰⁷ 11 U.S.C. § 506(c).

⁸⁰⁸ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁸⁰⁹ “Any time the trustee expends money to provide for the reasonable and necessary cost and expenses of preserving or disposing of a secured creditor’s collateral, the trustee is entitled to recover such expenses from the secured party or from the property securing an allowed secured claim held by such party.” 124 Cong. Rec. H11089 (Sept. 28, 1978), *reprinted in* 1978 U.S.C.C.A.N. 6436, 6451.

⁸¹⁰ See, e.g., *Loudoun Leasing Dev. Co. v. Ford Motor Credit Co. (In re K&L Lakeland, Inc.)*, 128 F.3d 203 (4th Cir. 1997); *In re TIC Memphis RI 13, LLC*, 498 B.R. 831 (Bankr. W.D. Tenn. 2013). See also *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000) (explaining that section 506(c) stems from practices under the Bankruptcy Act and “trac[ing] its origin to early cases establishing an equitable principle that where a court has custody of property, costs of administering and preserving the property are a dominant charge”) (citations omitted).

⁸¹¹ See 4 Collier on Bankruptcy ¶ 506.05[9] (16th ed. 2014).

⁸¹² See *id.*

⁸¹³ See *In re Flagstaff Foodservice Corp.*, 739 F.2d 73 (2d Cir. 1984). What costs are “reasonable” and “necessary” in the operation of the business again is a fact-specific inquiry. For example, in sale-based cases, under section 506(c), a court may entertain requests for: (i) the costs of plan completion after the sale of the asset (*i.e.*, “burial expenses”); (ii) professional expenses until the sale date; (iii) the tax consequences of any realized gain from the sale; (iv) payment of section 503(b)(9) claims; (v) break-up fees or expenses; and (vi) costs of preserving the going concern of a portion of a business that is sold.

⁸¹⁴ *In re Towne, Inc.*, 536 Fed. App’x 265 (3d Cir. 2013).

reasonable and necessary to preserve or monetize the collateral, and whether it provided some benefit to the secured creditor as a result. The statute clearly allows the trustee to assert a claim under section 506(c) for such expenses, and most courts have held that administrative claimants themselves lack standing to assert such claims.⁸¹⁵ In *Hartford Underwriters (In re Hen House)*, the U.S. Supreme Court specifically held that section 506(c) “does not provide an administrative claimant an independent right to use the section to seek payment of its claim.”⁸¹⁶ The Court declined to address, however, whether administrative claimants could assert such claims derivatively through the trustee.⁸¹⁷ Lower courts are split on this standing issue.⁸¹⁸

The payment of general administrative claims and other types of claims not related to the preservation or monetization of the secured creditor’s collateral is not addressed by section 506(c).⁸¹⁹ As discussed above, the language of section 506(c) links the use of collateral proceeds to costs associated in some way with that collateral, and courts generally construe the statute narrowly. The statute thus does not cover “carve-outs” from a secured creditor’s collateral to pay other administrative claims or unsecured claims. “As generally used, a carve out is an agreement between a secured lender, on the one hand, and the trustee . . . on the other, providing that a portion of the secured creditor’s collateral may be used to pay administrative expenses.”⁸²⁰

A secured creditor can agree with the trustee to allow certain costs and claims to be paid from the proceeds of the secured creditor’s collateral. Such carve-outs are common in debtor in possession financing facilities and are subject to approval by the court. The trustee may request authority to pay administrative claims and other claims from a secured creditor’s collateral, but absent satisfying the elements of section 506(c) or obtaining the secured creditor’s consent, courts generally deny requests for these types of surcharges.⁸²¹ In practice, debtor in possession financing facilities suggest that secured creditors may consent to limited carve-outs in exchange for an *ex ante* waiver of the debtor in possession’s right to surcharge the collateral under section 506(c).⁸²²

Section 506(c) and Charges Against Collateral: Recommendations and Findings

The scope of section 506(c) and a trustee’s ability to surcharge property has gained importance as debtors file chapter 11 cases with fewer unencumbered assets or little free cash flow to facilitate the reorganization. Any funds expended by the trustee on account of a secured creditor’s collateral arguably deplete the funds available to rehabilitate the debtor or pay general administrative claims.

⁸¹⁵ 11 U.S.C. § 506(c).

⁸¹⁶ *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1 (2000).

⁸¹⁷ *Id.*

⁸¹⁸ Standing to bring a section 506(c) claim was addressed in *In re Ramo Practice Mgmt., Inc.*, 2005 WL 6483309, at *1 (Bankr. S.D. Cal. June 17, 2005), where the court declined to grant the debtor’s attorney a section 506(c) claim for services rendered that fell within the “normal scope of services” and the trustee explicitly agreed with the court. In contrast, in *In re Sak Dev., Inc.*, 2008 WL 619378, at *1 (Bankr. E.D.N.C. Feb. 29, 2008), without any analysis of standing, the court granted a section 506(c) reimbursement claim to a creditor for work performed on a project.

⁸¹⁹ See, e.g., *United Jersey Bank v. Miller (In re C.S. Assocs.)*, 29 F.3d 903, 907 (3d Cir. 1994) (explaining that section 506(c) “was designed to extract from a particular asset the cost of preserving or disposing of that asset”).

⁸²⁰ Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 Am. Bankr. L. J. 445 (2002).

⁸²¹ See, e.g., *In re Cal. Webbing Indus., Inc.*, 370 B.R. 480 (Bankr. D.R.I. 2007).

⁸²² But see *In re Tenney Village Co., Inc.*, 104 B.R. 562, 567 (Bankr. D.N.H. 1989) (“Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate’s benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization and steal a march on other creditors in numerous ways.”).

Yet, from the secured creditor's perspective, the debtor's retention of the collateral is helping to facilitate the reorganization and delaying the secured creditor's ultimate recovery on the collateral.

The Commission considered these competing perspectives and the tension created when estate resources are devoted to the preservation or disposition of a secured creditor's collateral, and administrative claims and unsecured creditors are not being paid.⁸²³ The Commissioners discussed the types of claims typically surcharged against collateral under section 506(c), and the courts' approach to identifying whether a charge benefited the secured creditor. They also acknowledged that section 506(c) claims are litigated infrequently because those rights are commonly waived in connection with postpetition financing facilities or cash collateral agreements. This waiver often forces the trustee to rely on any consensual carve-outs negotiated in the case, or upon the secured creditor's *ex post* agreement to fund certain claims necessary to facilitate a sale of the collateral.

In light of these experiences, the Commission considered whether section 506(c) should be expanded to allow a court to charge a secured creditor's collateral for costs associated with the administration of the case that may not evidence a direct benefit to the secured creditor or the collateral. For example, the Commissioners engaged in an in-depth debate concerning costs incurred to wind down an estate subsequent to a sale of a secured creditor's collateral. Some of the Commissioners believed that such "burial costs" could provide a direct benefit to the secured creditor because, without some assurance that the case can be completed in an orderly fashion, the court should not allow the debtor and the secured creditor to sell the collateral under section 363 of the Bankruptcy Code. Other Commissioners disputed this characterization and noted that the secured creditor could have sold the collateral outside of bankruptcy and that often it is the debtor, and not the secured creditor, electing to invoke chapter 11. In this context, the Commissioners discussed the benefits of the chapter 11 process as providing a national foreclosure forum, the avoided costs to using the bankruptcy process, and whether the Bankruptcy Code should, as a matter of policy, permit chapter 11 to be used for this purpose. The Commissioners agreed that asset and business sales had become an integral part of the chapter 11 process and considered ways to balance competing claims to the debtor's limited resources in this environment.⁸²⁴

The Commission determined that the current scope of section 506(c) was appropriate, and that the required nexus between the estate's expenditures and the secured creditor's collateral was an appropriate gating feature of this provision.⁸²⁵ The Commissioners were comfortable with courts' interpretations and applications of the "reasonable" and "necessary" standards, as well as the circumstances in which secured creditors benefit from the expenditures. The Commissioners noted that in certain instances, burial costs and other costs associated with the operation of the business or the winding down of the case, may satisfy the section 506(c) elements, but that those determinations should be made by the courts on a case-by-case basis.

823 Barry E. Adler, *Priority in Going-Concern Surplus*, 2015 Ill. L. Rev. __ (forthcoming 2015) (discussing the potential difficulties of the proposed surcharge of the debtor's estate to reallocate a debtor's going-concern surplus instead of allowing it all to go to the secured creditor) (draft on file with Commission).

824 For a discussion of the payment of these costs in the sale context, see Section V.B.1, *General Provisions for Non-Ordinary Course Transactions* and Section VI.B, *Approval of Section 363x Sales*.

825 See, e.g., *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 4-5 (Nov. 15, 2012) (explaining that while "prepetition lending expectations should be preserved . . . the secured creditor should also be required to bear the reasonable costs and expenses incurred in connection with the preservation and disposition of the collateral (a concept presently addressed by §506(c) of the Code)"), available at Commission website, *supra* note 55.

The Commissioners observed that the utility of section 506(c) in this context turns in part on the trustee being able to assert, and the court being able to assess, claims for reimbursement of expenses under that section. If the trustee has waived its right to assert claims under section 506(c), the court does not have the opportunity to consider the appropriate allocation of expenses between the estate and the secured creditor.

The Commission considered whether this type of waiver should be permissible.⁸²⁶ Although the Commissioners recognized that even if section 506(c) claims are waived, the trustee may have negotiated a carve-out, and they did not believe that consensual carve-outs always represent a good alternative for the estate. The trustee typically has little bargaining leverage in negotiating the carve-out, and these provisions are limited in amount and can be limited in scope to only those items approved by the secured creditor. The Commissioners also expressed concerns regarding a waiver that impacts not just the trustee, but also other stakeholders who are beneficiaries of the estate.

On balance, the Commission determined that although section 506(c) should continue in its current form, the Bankruptcy Code should be amended to prohibit any waivers of, or stipulations regarding, a trustee's rights under section 506(c). The trustee's ability to invoke, and the court's authority to review, claims brought under section 506(c) should be preserved for the benefit of the entire estate. The Commissioners also believed that consensual carve-outs should still be permissible, but not to the exclusion of section 506(c) claims.

4. Section 552(b) and Equities of the Case

Recommended Principles:

- The trustee should not be able to waive, or to enter into any agreement affecting, a court's ability to limit or alter a secured creditor's interest in the debtor's or the estate's property based on the equities of the case under section 552(b) of the Bankruptcy Code.
- A trustee should not be required to establish an actual expenditure of funds to show that the estate enhanced the value of a secured creditor's collateral for purposes of the equities of the case determination under section 552(b). Rather, the trustee should be able to make such a showing with evidence of any value provided, obligation incurred, or other actions taken with respect to the collateral. With this clarification, the court should continue to determine the scope and meaning of the term "equities of the case" based on the facts of, and evidence presented in, the particular case.
- The Commission considered and declined to adopt a federal definition of the term "proceeds" for purposes of chapter 11 cases.

⁸²⁶ If approved in connection with postpetition financing, courts generally enforce the waivers. *See, e.g.,* Weinstein, Eisen & Weiss v. Gill (*In re* Cooper Commons LLC), 512 F.3d 533, 535–36 (9th Cir. 2008) (denying section 506(c) claim by debtor's former counsel, who represented the debtor in negotiating postpetition financing agreement including the waiver, based on *res judicata*).

Section 552(b) and Equities of the Case: Background

Section 552 of the Bankruptcy Code addresses the postpetition effect of prepetition liens on the debtor's property.⁸²⁷ Section 552(a) establishes the general rule that the bankruptcy filing cuts off a creditor's rights under any after-acquired property clause in a prepetition security agreement with the debtor.⁸²⁸ Section 552(b) sets forth two exceptions to this general rule, one dealing with proceeds of prepetition collateral,⁸²⁹ and the other dealing with rents and similar payments relating to prepetition collateral.⁸³⁰ The exceptions basically allow the secured creditor's prepetition lien to continue in postpetition proceeds of, or postpetition rents relating to, prepetition collateral. Each exception in turn is subject to an exception: the court, after notice and a hearing, may treat the secured creditor's prepetition lien differently "based on the equities of the case." The language of section 552(b) represents a compromise between the House and Senate versions of the 1978 bankruptcy bill: The final version allowed prepetition liens to continue in postpetition proceeds, but cabined such liens when necessary to protect the estate based on the equities of the case.⁸³¹

The equities of the case exception allows a court to limit, alter, or terminate the extension of a secured creditor's prepetition lien to postpetition property of the estate. Although the Bankruptcy Code does not define "equities of the case," the legislative history suggests that the exception was intended to compensate the estate for use of unencumbered property or expenditures that enhanced the value of the secured creditor's lien and to protect the rehabilitative purposes of the Bankruptcy Code. For example, the legislative history provides: "[T]he 'equities of the case' provision . . . is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally."⁸³² The Fourth Circuit has explained: "It appears clear from the legislative history related to § 552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code."⁸³³

In applying the equities of the case exception, courts generally consider three factors: (i) the amount of time and estate funds expended on the collateral; (ii) the relative position of the secured party

⁸²⁷ 11 U.S.C. § 552.

⁸²⁸ Section 552(a) provides: "Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a).

⁸²⁹ Section 552(b)(1) provides:

Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(b)(1).

⁸³⁰ 11 U.S.C. § 552(b)(2). The language of section 552(b)(2) is similar to that of section 552(b)(1) except that it applies "to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties." *Id.*

⁸³¹ Section 552(b) represents a compromise between the House bill and the Senate amendment. Proceeds clauses, but not after-acquired property clauses, are enforceable under the Bankruptcy Code. The provision allows the court to consider the equities of the case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in the secured party's position.

⁸³² 140 Cong. Rec. H. 10,768 (Oct. 4, 1994).

⁸³³ *United Va. Bank v. Slab Fork Coal Co. (In re Slab Fork Coal Co.)*, 784 F.2d 1188, 1191 (4th Cir. 1986), *cert. denied*, 477 U.S. 905 (1986).

following the expenditure of estate time and money (*i.e.*, whether the collateral has been enhanced); and (iii) the rehabilitative nature of the bankruptcy case.⁸³⁴ Neither the language of the statute nor the legislative history requires the estate to have devoted money or unencumbered assets to the improvement of the secured creditor's position, but some courts have applied the equities of the case exception in this manner. For example, in *Laurel Hill*, the court held that when a postpetition financing facility was repaid from proceeds that were subject to the security interests of various secured claimants whose liens had been transferred to the sale proceeds, the payments were not *at the expense of the estate* and thus did not support an equities of the case award to the unsecured creditors.⁸³⁵ Nevertheless, in *Residential Capital*, the court invoked the equities of the case exception under section 552(b)(1) to cut off the secured creditor's lien in postpetition goodwill when "time, effort, and expense by the Debtors' estates" enhanced the value of the assets sold in the case.⁸³⁶

Similar to section 506(c), the trustee⁸³⁷ often waives its right to assert the equities of the case exception under section 552(b), or stipulates that no such equities exist, in connection with postpetition financing or the use of cash collateral.⁸³⁸ Perhaps because of these waivers, relatively little case law exists on section 552(b).

Section 552(b) and Equities of the Case: Recommendations and Findings

Section 552 represents a basic compromise: Prepetition secured creditors can maintain their interests in the debtor's prepetition property, including proceeds, but the trustee can use property acquired by the estate unencumbered by any prepetition liens. This balance provides the trustee with resources to help facilitate the debtor's reorganization. Nevertheless, to the extent the trustee expends any of these or other estate resources in a manner that enhances the value of a secured creditor's collateral, section 552(b) permits the court to assess the equities of allowing the secured creditor to retain that enhancement.

The Commissioners observed the relationship between sections 506(c) and 552(b) of the Bankruptcy Code in that both seek to give the secured creditor the value of its allowed secured claim while preventing the secured creditor from receiving any windfalls in the case. These sections are also tied in certain respects to the valuation of a secured creditor's collateral for purposes of adequate protection requests and ultimate distributions in the case. Accordingly, the Commission considered the appropriate scope and use of section 552(b) in the context of the recommended principles relating to section 506(c), foreclosure value, and reorganization value.⁸³⁹

⁸³⁴ See *In re Laurel Hill Paper Co.*, 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008).

⁸³⁵ *Id.*

⁸³⁶ See Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

⁸³⁷ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁸³⁸ For example, the court made the following finding in its final order approving postpetition financing in the *General Growth Properties* chapter 11 case:

In light of the Lenders' agreement to subordinate their liens and superpriority claims to the Carve-Out, the Lenders are entitled to a waiver of (i) the provisions of section 506(c) of the Bankruptcy Code and (ii) any "equities of the case" claims under section 552(b) of the Bankruptcy Code, in each case, in respect of the DIP Documents.

In re Gen. Growth Props., Inc., 09-11977 (ALG) (May 14, 2009).

⁸³⁹ See Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.

The Commissioners identified several issues in the application of section 552(b), including defining the scope of the secured creditor's prepetition collateral package and the broad interpretation of "proceeds" and related terms under applicable state law. With respect to collateral identification, the Commission reviewed the *Residential Capital* decision and its discussion of postpetition goodwill by the Honorable Martin Glenn of the U.S. Bankruptcy Court of the Southern District of New York.⁸⁴⁰ In that case, Judge Glenn rejected the prepetition secured creditor's claim to postpetition goodwill on several grounds. Specifically, he determined that the prepetition secured creditors failed to show that their collateral was converted into postpetition goodwill and that, even if the secured creditor's collateral "was used to generate goodwill (either by maintaining or improving the value of assets or by diminishing liabilities), Debtor resources were used as well."⁸⁴¹ Judge Glenn concluded that the use of the debtor's resources, at least in part, to transform the collateral into postpetition goodwill precluded the goodwill from being characterized as proceeds for purposes of section 552(b).

The Commissioners debated the facts and holding in *Residential Capital* and the potential approaches to resolving those issues. Some of the Commissioners supported excluding all postpetition goodwill from a prepetition secured creditor's collateral package. They reasoned that the value generated postpetition by the debtor in possession's efforts and resources, as well as value associated with costs and obligations avoided through the chapter 11 process, should be available to support the debtor's reorganization. The Commissioners discussed the impact of such a bright-line rule regarding goodwill on credit markets and the challenge of allocating value between prepetition and postpetition goodwill. The Commission agreed that the treatment of goodwill was best determined through a case-specific inquiry based on the facts of the case and the evidence presented at the hearing.

Similarly, the Commissioners examined the scope of the term "proceeds" under state law. Several of the Commissioners noted the significant expansion of the definition of proceeds under state law since the enactment of the Bankruptcy Code in 1978. They discussed how these kinds of amendments arguably allowed state commercial law to restrict the resources available to support a debtor's reorganization under chapter 11. They provided examples of parties litigating the scope of proceeds and reflected on two articles by Professor Ray Warner concerning the continued expansion of the concept under state law.⁸⁴² Professor Warner posits that certain amendments to Article 9 of the Uniform Commercial Code, including the expanded definition of proceeds, "had little or no nonbankruptcy function, but were designed primarily to alter bankruptcy law outcomes in favor of secured creditors."⁸⁴³ Several of the Commissioners supported a federal definition of proceeds that would scale back the definition to the replacement or substitution of collateral concept originally assigned to proceeds of collateral. Other Commissioners suggested that a federal definition of proceeds that conflicted with state law would create uncertainty and increase costs in secured credit transactions. The Commission ultimately declined to adopt a federal definition of proceeds.

840 Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re Residential Capital, LLC*), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

841 *Id.*

842 See, e.g., G. Ray Warner, *Article 9's Bankrupt Proceeds Rule: Amending Section 552 Through the UCC's "Proceeds" Definition*, 46 Gonzaga L. Rev. 521 (2011); G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 Am. Bankr. Inst. L. Rev. 3, 5–6 (2001). See also Moringiello, *When Does Some Federal Interest Require a Different Result?*, *supra* note 280 ("The Code recognizes the secured creditor's entitlement to the value of its collateral, and also recognizes that the creditor's security interest extends to proceeds of its collateral, even if those proceeds are realized after the debtor has filed for bankruptcy. The 2001 Amendments to Article 9 of the Uniform Commercial Code expanded the definition of proceeds to include 'rights arising out of the collateral' a definition that could so expand the idea of proceeds as to deprive unsecured claimants of any recovery at all.").

843 Warner, *Article 9's Bankrupt Proceeds Rule*, *supra* note 842, at 521.

The Commissioners then considered whether section 552(b) strikes the appropriate balance between the rights of secured creditors and the estate. The Commissioners generally agreed with the continuation of a secured creditor's lien in proceeds subject to the equities of the estate exception, but several of the Commissioners expressed discomfort with the kinds of expenditures and evidence required for the trustee to establish the exception. These Commissioners commented that, if the section is concerned with enhancements of value and promoting rehabilitation, the trustee should be able to satisfy the equities of the case exception with evidence of the estate contributing value, whether through time, effort, money, property, other resources, or cost savings. The basic premise should be that, if the estate creates value through any means during the chapter 11 case and such value enhances the secured creditor's collateral, the estate should receive the benefit of such value. The extent of value attributed to the estate would be determined by the court based on the evidence presented under the equities of the case exception. The Commission agreed that so long as the evidence establishes the estate's expenditures (in whatever form), this clarification to the scope of the equities of the case exception would be beneficial and aligned with the objectives of the related principles.

Finally, as with section 506(c) and for similar reasons, the Commission voted to recommend that parties not be permitted to waive the equities of the case exception under section 552(b) or to stipulate that no equities exist to invoke the exception. The Commission agreed that such determinations should be made *ex post* based on the circumstances of the case and the evidence presented by the parties.

5. Cramdown Interest Rates

Recommended Principles:

- Under section 1129(b)(2)(A), the court should apply an appropriate discount rate to determine the present value of any deferred cash payments being made to the secured creditor under the chapter 11 plan on account of the creditor's allowed secured claim. The present value of such deferred cash payments should equal at least the amount of the secured creditor's allowed secured claim as of the effective date of the chapter 11 plan.
- In selecting the appropriate discount rate, the court should consider the evidence presented by the parties at the confirmation hearing and, if practicable, use the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity, taking into account the size and creditworthiness of the debtor and the nature and condition of the collateral, among other factors. If such a market rate is not available or the court determines that an efficient market does not exist, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as the debtor's industry, projections, leverage, revised capital structure, and obligations under the plan. The court should not apply the "prime plus" formula adopted by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) in the chapter 11 context.

Cramdown Interest Rates: Background

Section 1129(b)(2)(A) sets forth three options for cramming down secured creditors. The plan must generally (i) permit the secured creditor to retain its lien and provide the secured creditor with deferred cash payments having a present value equal to the amount of the secured creditor's allowed secured claim; (ii) sell the collateral and permit the secured creditor's lien to attach to the proceeds; or (iii) provide the secured creditor with the indubitable equivalent of its claim. Although the first option of lien retention and cash payments is relatively straightforward as a concept, its application has proven challenging.

The primary issue under the first option is the appropriate discount rate (*i.e.*, interest rate) for calculating the present value of the deferred cash payments to ensure that the secured creditor receives total distributions under the plan equal to the allowed amount of its secured claim as of the effective date of the plan. The objective is to make sure payments received by the secured creditor in the future represent the value of its secured claim on the effective date (following the general principle that a dollar received today is more than a dollar received tomorrow). The discount rate used by the court affects the amount of deferred cash payments required under the plan to satisfy section 1129(b)(2)(A)(i).

There are several approaches to determining an appropriate discount rate for purposes of section 1129(b)(2)(A)(i), including the "formula" approach (also referred to as the "prime plus" approach), the "coerced loan" approach, the cost of funds approach, and the "presumptive contract rate" approach. Prior to 2004, courts applied different approaches, often based on the circumstances of the case before it. Nevertheless, in 2004, the Supreme Court adopted the formula approach for purposes of a chapter 13 plan in *Till v. SCS Credit Corp.*⁸⁴⁴ Specifically, the Supreme Court determined that for purposes of calculating the present value of deferred cash payments to a secured creditor under a chapter 13 plan, a court should use the risk-free rate of interest at the time of the determination, adjusted by 100 to 300 basis points to account for the risk of default in the given case, the nature and quality of the collateral, and the duration and feasibility of the chapter 11 plan.⁸⁴⁵

In *Till*, the Supreme Court was faced with a consumer loan used by the chapter 13 debtors to purchase a truck prior to the petition date. At the time of the plan, the debtors owed approximately \$4,895 to the lender, and the truck was valued at approximately \$4,000. A plurality of the Supreme Court determined that the formula or prime plus approach was simple, cost-effective, and the most appropriate approach for determining the present value of the proposed deferred cash payments to the lender under the plan. As observed by the Court, "[u]nlike the other approaches proposed in this case, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary hearings."⁸⁴⁶

Although the Supreme Court noted that its decision was limited to the chapter 13 context, and some dicta in the decision suggest that the analysis may be quite different for chapter 11 cases,⁸⁴⁷

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

⁸⁴⁵ *Id.*

⁸⁴⁶ *Id.*

⁸⁴⁷ For example, the Supreme Court notes the following in a footnote:

This fact helps to explain why there is no readily apparent Chapter 13 "cram down market rate of interest": Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of

some courts have followed the *Till* formula approach for purposes of section 1129(b)(2)(A)(i).⁸⁴⁸ For example, in *In re MPM Silicones LLC*, the court adopted the *Till* formula approach in the chapter 11 context, noting that the Supreme Court had specifically rejected the coerced loan approach in *Till* because that approach required courts to consider market rates and such rates might include profit components not available in bankruptcy.⁸⁴⁹ In so holding, the *MPM Silicones* court placed little value on the Supreme Court's dicta in *Till*.

Other courts and commentators have criticized the use of a formula approach in chapter 11 cases.⁸⁵⁰ These commentators focus on the differences in debt instruments and assets in a chapter 11 and a chapter 13 case, and that an efficient market is more readily ascertainable for chapter 11 debt. They further argue that *Till*'s oversimplified approach to the present value calculation frequently undervalues the secured creditor's claim. Finally, critics suggest that the application of the formula approach to chapter 11 cramdown payments could negatively impact distressed debt markets and the liquidity that flows from those markets.

Cramdown Interest Rates: Recommendations and Findings

The Commission recognized the uncertainty created by the Supreme Court's decision in *Till* and the different interpretations of that decision by lower courts. The Commissioners discussed the potential methods for calculating present value for purposes of cramdown under section 1129(b)(2)(A)(i). Some of the Commissioners found the simplicity and certainty of the *Till* formula approach attractive. Other Commissioners argued for use of market comparables, recognizing that a market typically will exist for the kinds of debt instruments and the businesses/assets at issue in chapter 11 cases. Still other Commissioners suggested a hybrid approach that would establish a formula to guide the court's determination, but that would consider factors more relevant to chapter 11 cases. For example, the court could consider the weighted average cost of capital component for the particular tranche of debt at issue in the discounted cash flow valuation accepted by the court for purposes of determining the debtor's enterprise value in connection with confirmation of the chapter 11 plan.

The Commissioners did not try to decipher the Supreme Court's holding or dicta in *Till*; rather, they focused on the purpose of section 1129(b)(2)(A)(i) and the best method to achieve that objective. The Commission agreed that the section was intended to provide the secured creditor with the

willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Id. at 476 n. 14 (citing to websites advertising debtor in possession lending).

848 See, e.g., *In re Tex. Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324 (5th Cir. 2013); *In re Mendoza*, 2010 WL 1610120 (Bankr. N.D. Cal. Apr. 20, 2010); *In re Princeton Office Park, L.P.*, 423 B.R. 795 (Bankr. D.N.J. 2010); *In re Price Funeral Home, Inc.*, 2008 WL 5225845 (Bankr. E.D.N.C. Dec. 12, 2008); *In re Deep River Warehouse, Inc.*, 2005 WL 2319201 (Bankr. M.D.N.C. Sept. 22, 2005); *In re Field*, 2005 WL 3148287 (Bankr. D. Idaho Oct. 17, 2005).

849 *In re MPM Silicones, LLC*, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (explaining that cramdown is intended to "put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately . . . the value of a creditor's allowed claim does not include any degree of profit").

850 See, e.g., *Bank of Montreal v. Official Comm. of Unsecured Creditors (In re Am. HomePatient, Inc.)*, 420 F.3d 559 (6th Cir. 2005), cert. denied, 549 U.S. 942 (2006); *Gen. Elec. Credit Equities, Inc. v. Brice Rd. Devs., L.L.C. (In re Brice Rd. Devs., L.L.C.)*, 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008); *In re DBSD N. Am., Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *In re Good*, 413 B.R. 552 (Bankr. E.D. Tex. 2009), *aff'd sub nom. Good v. RMR Invs., Inc.*, 428 B.R. 249 (E.D. Tex. 2010); *In re Winn-Dixie Stores, Inc.*, 356 B.R. 239 (Bankr. M.D. Fla. 2006).

value of its allowed secured claim as of the effective date of the plan, even if that amount would be paid over an extended period of time. In other words, the secured creditor should receive the same return, regardless of whether the debtor elects to pay the allowed secured claim in cash on the effective date or through deferred cash payments over several years. Accordingly, the discount rate applied to the deferred cash payments should reflect the economic realities of the case, including the rate of interest available on similar debt and risks associated with the future income stream available to fund the payments. Some of the Commissioners also asserted that any discount rate should factor in the opportunity costs associated with the deferred cash payments.

The Commissioners debated the precise calculation method, discussing each of the potential approaches identified above (*i.e.*, the formula approach, a cost of capital/market comparables approach, and a weighted average cost of capital approach). They generally agreed that it was difficult to develop a one-size-fits-all approach. In some cases, markets may be efficient and provide relevant data; in other cases, markets may be dysfunctional and a prime plus type formula may produce more reliable results. Accordingly, the Commission voted to recommend: (i) clarifying section 1129(b)(2)(A)(i)(II) to emphasize the present value calculation required to implement the purpose of that section; (ii) adopting a general market approach to determining an appropriate discount rate; and (iii) rejecting the *Till* “prime plus” formula.

The Commissioners discussed how courts could best ascertain appropriate market rates in any given case. They examined various factors and approaches. After extensive deliberation, the Commission concluded that, as a general matter, the court should use the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity. The Commission further agreed that if a market rate cannot be determined for a particular debtor, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor considering factors such as the debtor’s industry, projections, leverage, revised capital structure, and obligations under the plan. The Commission did not find the prime plus formula articulated in *Till* appropriate for business chapter 11 cases, even if an efficient market does not exist. Among other things, the discount rate used in that prime plus formula is not based on the economic realities of the particular case and, consequently, likely undercompensates creditors for the risk present in the postconfirmation credit.

6. Class-Skipping and Intra-Class Discriminating Distributions

Recommended Principles:

- Senior creditors should not be permitted to make class-skipping, class-discriminating, or intra-class discriminating transfers to junior creditors or interest holders under a chapter 11 plan if such transfers would violate the absolute priority rule of section 1129(b)(2)(B)(ii) or section 1129(b)(2)(C)(ii) of the Bankruptcy Code.

Class-Skipping and Intra-Class Discriminating Distributions: Background

Creditors frequently contest the debtor's proposed allocation of value and related distributions in the chapter 11 case. These disputes may focus on the valuation of the debtor's assets or business or the validity or priority of creditors' claims. In either scenario, the junior creditors' claims may in fact be entitled to a portion of the value available for distribution in the case, or they may at least have "holdup value." Creditors' claims have holdup value when they have meritorious or colorable claims against the senior creditors and the resolution of those claims is delaying distributions in the case. This potential delay can arise with respect to sale proceeds or in the context of a chapter 11 plan, particularly in the cramdown context under section 1129(b).

Courts are divided as to the permissibility of class-skipping transfers in chapter 11 cases. Some courts view class-skipping transfers as a voluntary arrangement between the senior creditors giving, and the junior creditors receiving, the transfers (also referred to as "gifting" in this context).⁸⁵¹ Once the value of the senior creditors' allowed claims are determined, these courts hold that the senior creditors can use or allocate that value in any manner suitable to them. The working assumption underlying these cases is that the senior creditors are using their own money to pay the junior creditors so the estate is not harmed. To the contrary, many commentators and some courts assert that class-skipping gifts lead to efficient resolutions and foster the bankruptcy policy of consensual plans.⁸⁵²

Other courts refuse to approve class-skipping transfers.⁸⁵³ These courts focus on the purpose of the absolute priority rule and view class-skipping transfers as a workaround of the Bankruptcy Code's confirmation standards. They also raise concerns regarding self-enrichment and collusive activities that can benefit some stakeholders at the expense of others who do not have sufficient bargaining power to participate in the negotiations. These courts are also willing to designate the senior creditor's votes under section 1126(e) of the Bankruptcy Code for, among other things, facilitating a payment in contravention of the Bankruptcy Code for its own benefit and to the exclusion or harm of others.

The concerns with class-skipping transfers find their origins in *Northern Pacific Railway Co. v. Boyd*.⁸⁵⁴ The *Boyd* case involved an equity receivership of a railroad in which the secured creditors transferred part of their recovery to the prepetition equity security holders, while unsecured creditors in the case received no recoveries. The U.S. Supreme Court held that "[a]ny device . . . whereby stockholders were preferred before the creditor was invalid [under the Bankruptcy Act]."⁸⁵⁵ Accordingly, *Boyd* is one of the key cases in the development of the absolute priority rule and the fair and equitable standard used in the cramdown context under section 1129(b) of the Bankruptcy Code.⁸⁵⁶ Supreme Court cases addressing the absolute priority rule under the Bankruptcy Code focus primarily on

851 See, e.g., *In re SPM Mfg. Corp.*, 984 F.2d 1305 (1st Cir. 1993) (permitting class-skipping in chapter 7 case). For a discussion of gifting and the *SPM* case, see Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 Am. Bankr. L.J. 663, 711 (2009).

852 See, e.g., *In re DBSD N. Am., Inc.*, 419 B.R. 179, 187–88 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

853 See, e.g., *DISH Network Corp. v. DBSD N. Am., Inc.* (*In re DBSD N. Am., Inc.*), 634 F.3d 79 (2d Cir. 2011); *In re Armstrong World Indus.*, 432 F.3d 507 (3d Cir. 2005).

854 *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

855 *Id.* at 504.

856 See also *In re Iridium Operating LLC*, 478 F.3d 452, 463 n. 17 (2d Cir. 2007) ("The absolute priority rule originated as a 'judicial invention designed to preclude the practice in railroad reorganizations of 'squeezing out' intermediate unsecured creditors through collusion between secured creditors and stockholders (who were often the same people.')" (citations omitted)).

whether equity security holders can receive distributions under a plan on account of new value contributed to the plan.⁸⁵⁷

Class-Skipping and Intra-Class Discriminating Distributions: Recommendations and Findings

Debtors are increasingly seeking to confirm their plans on a nonconsensual basis with one or more classes of creditors. Although consensual plans are the desired result, achieving a fully consensual plan is difficult in cases with valuation disputes and one or more classes of creditors significantly impaired or arguably out of the money. In such cases, allowing senior creditors to pay a small gift or tip to junior creditors can resolve objections to plan confirmation, facilitate the debtor's reorganization, and disperse value further down the debtor's capital structure.⁸⁵⁸ From this perspective, the absolute priority rule can be viewed as frustrating distribution to junior creditors. The Commission studied the impact of the absolute priority rule in a variety of circumstances in chapter 11 cases.

The Commissioners recognized the high hurdle frequently posed by the absolute priority rule and the fair and equitable standard in cramdown cases. They considered eliminating the absolute priority rule or adopting a relative priority standard. They evaluated academic articles discussing these alternatives, as well as an in-depth report on these articles and the related issues from the advisory committee. The Commissioners generally favored lowering barriers to confirmation of feasible plans, particularly if such plans provided distributions to more creditors. They were not willing to do so, however, at the expense of creditor priorities or appropriate checks on self-interested behavior and undue influence by creditors.

In the context of class-skipping transfers (*i.e.*, nonconsensual gifting), the Commissioners reviewed the historical underpinnings of the absolute priority rule. They debated the policies underlying the Supreme Court decisions in *Boyd*⁸⁵⁹ and *Los Angeles Lumber*.⁸⁶⁰ The Commissioners weighed the benefits of using class-skipping transfers to facilitate confirmation against concerns regarding senior creditors imposing their will or unduly influencing plan negotiations if payments outside of the strict priority waterfall were permitted. They also discussed recent cases in which gifting was either permitted or denied (including *DBSD*⁸⁶¹ and *Iridium*⁸⁶²), and the justifications for variations from the absolute priority rule. The Commission agreed that — in the nonconsensual (*i.e.*, cramdown) context — the potential abuses of gifting outweighed any benefits in class-skipping, class-discriminating, and intra-

857 See *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 437 (1999); *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 206 (1988). The Second Circuit has interpreted these cases as endorsing a strict interpretation of the absolute priority rule. See *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 97 (2d Cir. 2011).

858 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 15 (Nov. 15, 2012) ("CFA believes that senior creditors should be permitted to reallocate their recovery to junior classes because doing so would foster the reorganization process, even if it means skipping out-of-the-money junior classes. The law should favor efficient ventures between managers and senior lenders and encourage reorganizations that share in the growth in the value of the debtor. Accordingly, CFA encourages the Commission to reexamine the prohibition against 'gift plans.'"), available at Commission website, *supra* note 55.

859 *N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

860 *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106 (1939).

861 See *DISH Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.)*, 634 F.3d 79, 97 (2d Cir. 2011).

862 See *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007) (holding that "a rigid *per se* rule cannot accommodate the dynamic status of some preplan bankruptcy settlements" but that "whether a particular settlement's distribution scheme complies with the [Bankruptcy] Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable'").

class discriminating cases. Some of the Commissioners also emphasized the need to define the phrase “under a chapter 11 plan” broadly to prohibit direct or indirect gifting under plans.

D. Disclosure and Use of Postconfirmation Entities and Claims Trading

Recommended Principles:

- “*Adequate information*” for purposes of section 1125(a) should include (i) specific information regarding the governance of, and assets being transferred to, the reorganized debtor, any successor to the debtor, or any postconfirmation entity (including any litigation trust), as well as drafts of the operative documents; (ii) the mechanics for resolving claims and making distributions postconfirmation to holders of claims and interests under the chapter 11 plan; and (iii) the procedures for parties to raise and resolve any postconfirmation issues relating to the chapter 11 plan or any postconfirmation entity (including a litigation trust).
- The debtor or plan proponent should be permitted to use a postconfirmation entity (including any litigation trust) under a chapter 11 plan only to the extent that the court finds, in connection with the confirmation hearing and order, that the postconfirmation entity (including any litigation trust) and the material terms governing its operation sufficiently protect the interests of the beneficiaries of such entity or trust.
- No change is suggested with respect to the current law governing the trading of claims in a chapter 11 case or the disclosures required by Bankruptcy Rule 2019.

Disclosure and Use of Postconfirmation Entities and Claims Trading: Background

Disclosure Concerning Postconfirmation Governance and Postconfirmation Entities

Chapter 11 requires a debtor or plan proponent to disclose various information concerning the debtor’s business, chapter 11 case, and proposed chapter 11 plan in a disclosure statement.⁸⁶³ The disclosure statement, together with the proposed plan, must then be approved by the court and distributed to creditors and other stakeholders. The primary purpose of the disclosure statement is to provide stakeholders with adequate information to evaluate and cast a vote on the proposed plan.⁸⁶⁴ Specifically, section 1125(b) provides: “An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to

⁸⁶³ 11 U.S.C. § 1125.

⁸⁶⁴ The legislative history of section 1125 provides: “This section is new. It is the heart of the consolidation of the various reorganization chapters found in current law. It requires disclosure before solicitation of acceptances of a plan of reorganization.” H.R. Rep. No. 95-595, at 409 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6365.

such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.”⁸⁶⁵

The key inquiry in assessing a debtor’s or plan proponent’s disclosure statement is whether it contains adequate information. The Bankruptcy Code defines “adequate information” as follows:

“[A]dequate information” means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information. . . .⁸⁶⁶

Moreover, courts have developed a list of factors to guide their review in this context. These factors consider whether the disclosure statement discusses, among other things (i) the circumstances giving rise to the chapter 11 case; (ii) the debtor’s assets and liabilities; (iii) the company’s future business plans and the funding sources for those endeavors; (iv) information regarding the chapter 11 case, including claims, litigation, and the condition of the debtor’s business; (v) an analysis of recoveries for creditors under the plan and in a hypothetical chapter 7 liquidation; (vi) the debtor’s financial condition, a valuation of the business, and projected future performance; (vii) the tax consequences of the plan; and (viii) risks posed to creditors under the plan.⁸⁶⁷ Overall, courts assess whether the disclosure statement identifies and explains material aspects of the debtor’s business, chapter 11 case, and proposed plan so that creditors and other stakeholders can make an informed decision about voting on the plan.⁸⁶⁸

A key area of discussion in a disclosure statement from the creditors’ perspective is often the information provided concerning the future operation of the business and how claims, recoveries, and distributions will be handled postconfirmation. The former is of particular importance in cases in which creditors are receiving equity or another security whose value is dependent on the future success of the business. The latter is crucial when a litigation or liquidation trust (or other postconfirmation entity) is being established to, for example, pursue claims and causes of action that belong to the estate, review claims asserted against the estate, and make distributions to creditors.⁸⁶⁹

⁸⁶⁵ 11 U.S.C. § 1125(b).

⁸⁶⁶ *Id.* § 1125(a).

⁸⁶⁷ See, e.g., *In re U.S. Brass Corp.*, 194 B.R. 420, 424 (Bankr. E.D. Tex. 1996); *In re Cardinal Congregate I*, 121 B.R. 760, 765 (Bankr. S.D. Ohio 1990); *In re Scioto Valley Mortg. Co.*, 88 B.R. 168, 170 (Bankr. S.D. Ohio 1988); *In re Metrocraft Publ’g Servs., Inc.*, 39 B.R. 567 (Bankr. N.D. Ga. 1984).

⁸⁶⁸ See, e.g., *In re Copy Crafters Quickprint, Inc.*, 92 B.R. 973, 980 (Bankr. N.D.N.Y. 1988) (denying motion to approve disclosure statement where disclosures were “unsupported by factual information so that voting parties were unable to independently evaluate the merits of the plan”) (citations omitted).

⁸⁶⁹ For a general explanation of the use and potential issues with postconfirmation entities, see Andrew M. Thau et al., *Postconfirmation Liquidation Vehicles (Including Liquidating Trusts and Postconfirmation Estates): An Overview*, 16 Norton J. Bankr. L. & Prac. 201

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In both, creditors and the court must receive sufficient information to understand the mechanics of the plan postconfirmation and to determine whether the plan complies with the Bankruptcy Code and other applicable nonbankruptcy law.

Disclosure and Role of Claims Trading

The term “claims trading” generally refers to the buying and selling of claims against a bankrupt company. For example, a debtor’s supplier may sell its claim for unpaid goods to an investor at a discount in order to monetize its claim quicker and avoid interaction with the bankruptcy case. Investors also actively trade claims they own as lenders, as well as those that they purchase from other creditors. Although the practice of claims trading is not new, it has grown exponentially in recent years. As explained by one industry publication, “A slowdown in large corporate Chapter 11 filings in 2012 didn’t stop distressed investors, who bought and sold more than \$41 billion worth of bankruptcy claims last year.”⁸⁷⁰

Commentators debate the impact of claims trading on chapter 11 cases. Critics suggest that claims trading (i) destabilizes the debtor’s reorganization efforts, (ii) removes creditors with a vested interest in the debtor’s business from the process, and (iii) provides arbitrage and takeover opportunities for investors that may depress value and harm other creditors.⁸⁷¹ Proponents suggest that claims trading: (i) provides liquidity to, and an efficient exit strategy for, creditors who do not want to be involved in the case, (ii) may consolidate claims against the debtor and minimize the number of stakeholders the debtor must negotiate with to achieve a consensual plan, and (iii) may permit the entry of longer-term, well-capitalized investors into a restructuring process through claims purchasing, which may result in increased access to debtor in possession and exit financing.⁸⁷² Commentators also assert that the possibility of an early exit and return for creditors increases liquidity overall in capital markets and allows a more forgiving investment environment.

A review of the literature on claims trading reveals that transparency and disclosure are key issues in this debate. To that end, Bankruptcy Rule 2019 was amended in 2011 to increase disclosures by investors that are members of *ad hoc* committees, groups, or investors otherwise acting collectively in the bankruptcy case. Bankruptcy Rule 2019 requires investors in these circumstances to disclose,

(2007). See also William L. Medford, *Retention of Claims Post-Confirmation: Fifth Circuit Clarifies Necessary Level of Specificity*, Am. Bankr. Inst. J., Dec./Jan. 2012, at 24; Andrew J. Morris, *Clarifying the Authority of Litigation Trusts: Why Post-Confirmation Trustees Cannot Assert Creditors’ Claims Against Third Parties*, 20 Am. Bankr. Inst. L. Rev. 589 (2012); Robert M. Quinn, *Not So Fast, Mr. Liquidating Trustee! May Anyone Other Than a Bankruptcy Trustee Exercise Avoidance Powers After Confirmation?*, Am. Bankr. Inst. J., Apr. 2003, at 28.

870 Dow Jones Daily Bankr. Rev., Jan. 28, 2013.

871 See, e.g., Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 Colum. Bus. L. Rev. 610 (2008) (discussing potential issues with bankruptcy claims trading and voting in chapter 11); Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. U. L. Rev. 1684 (1996) (analyzing advantages and disadvantages for claims trading); Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11s*, Am. Bankr. Inst. J., July/Aug. 2010, at 1 (“Despite the vast benefits created by the market, claims trading has also generated negative implications on the structure of the reorganization process.”).

872 See, e.g., *Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the value of the distressed debt market for debtors), available at Commission website, *supra* note 55; *Written Statement of Jennifer Taylor: WLC Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Nov. 30, 2012) (same), available at Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing liquidity offered by distressed debt markets), available at Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), available at Commission website, *supra* note 55; *Written Statement of the Honorable Edith H. Jones, Fifth Circuit Court of Appeals: VALCON Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–3 (Feb. 21, 2013) (noting that claims trading improves liquidity and reduces risk for traditional lenders), available at Commission website, *supra* note 55.

among other things, their names, addresses, and nature and amount of each “disclosable economic interest” they hold against the debtor. In addition, courts have addressed questionable conduct by investors in the claims trading context through various means, including by reducing the investor’s claim, subordinating the investor’s claim, or designating the investor’s vote on the chapter 11 plan.⁸⁷³ Commentators continue to debate the utility of claims trading and regulation of the bankruptcy claims trading market.⁸⁷⁴

Disclosure and Use of Postconfirmation Entities and Claims Trading: Recommendations and Findings

Disclosure Concerning Postconfirmation Governance and Postconfirmation Entities

The Commissioners discussed the kinds of information necessary to inform stakeholders about key components of the chapter 11 plan. The Commission determined that, as a general matter, debtors and plan proponents provide an acceptable level of disclosures with respect to events leading up to, and occurring during, the chapter 11 case, as well as with respect to the current state of its assets, liabilities, and business. Many of the Commissioners believed, however, that disclosure is frequently insufficient with respect to the governance and operations of the reorganized debtor and any postconfirmation entity established in connection with the plan.

The Commissioners discussed the proliferation of postconfirmation entities in chapter 11 plans. These entities can take a variety of forms, including a litigation trust, a liquidation trust, a postconfirmation business trust, or the reorganized debtor itself when the debtor is no longer operating a business, but is solely winding down the affairs of the estate outside of the bankruptcy process. Section 1123(b) states that a plan may provide for “the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or . . . the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest.”⁸⁷⁵ Debtors and plan proponents generally rely on the language of section 1123(b) to establish a postconfirmation entity under a plan, and courts approving such entities often perceive them as a means to efficiently resolve the chapter 11 case.⁸⁷⁶

⁸⁷³ Courts have reduced claim amounts with respect to insiders or other fiduciaries. *See, e.g., In re MC2 Capital Partners, LLC*, Case No. 11-14366 (Bankr. N.D. Cal. Feb. 27, 2013) (“[T]he exception to the general rule that transfers are to be taken at face value applies when the transferee has fiduciary duties to the debtor or the transfer is an attempt to circumvent the consequences of those duties.”); *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims (In re Papercraft Corp.)*, 211 B.R. 813, 825 (W.D. Pa. 1997), *aff’d*, 160 F.3d 982 (3d Cir. 1998); *Bernstein v. Donaldson (In re Insulfoams, Inc.)*, 184 B.R. 694 (Bankr. W.D. Pa. 1995), *aff’d sub nom. Donaldson v. Bernstein*, 104 F.3d 547 (3d Cir. 1997). Equitable subordination is addressed by section 510(c) of the Bankruptcy Code and generally requires some harm (*e.g.*, delay in emergence from bankruptcy or impairment of other creditors) resulting from the alleged inequitable conduct. *See, e.g., Shubert v. Lucent Techs. Inc. (In re Winstar Commc’ns, Inc.)*, 554 F.3d 382, 413 (3d Cir. 2009) (“A bankruptcy court should attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the subordination.”) (citations omitted). Section 1126(e) provides a mechanism for disqualification (known as “designation”) of an acceptance or rejection of a plan if the acceptance or rejection was not obtained in good faith or the vote to accept or reject was not cast in good faith. 11 U.S.C. § 1126(e) (“On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith or was not solicited or procured in good faith or in accordance with the provisions of this title.”).

⁸⁷⁴ *See, e.g., Adam J. Levitin, Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67 (2010); *Maneuvering in the Shadows of the Bankruptcy Code: How to Invest or Take Over Bankruptcy Companies Within the Limits of the Bankruptcy Code*, 30 Emory Bankr. Dev. J. 73 (2013); Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 Wash. U. L. Rev. 155 (2011).

⁸⁷⁵ 11 U.S.C. § 1123(b)(3). *See also In re Sweetwater*, 884 F.2d 1323 (10th Cir. 1989) (explaining that an estate representative under section 1123 “may not be accomplished by unilateral declaration of the debtor in possession”).

⁸⁷⁶ *See, e.g., In re Acequia, Inc.*, 34 F.3d 800 (9th Cir. 1994) (“[The] aim [of section 1123(b)(3)(B)] was to make possible the formulation and consummation of a plan before completion of the investigation and prosecution of causes of action such as

The Commissioners recognized the potential utility of postconfirmation entities in facilitating plan implementation and a debtor's emergence from chapter 11. Some of the Commissioners expressed concerns, however, regarding the uncertainty of the postconfirmation entity's authority, governance, operation, and accountability after confirmation of the plan. Although the terms of these entities are set forth in the trust or other organizational documents, those documents are not often filed with the court until immediately before the confirmation hearing, giving parties little time to review the documents and depriving stakeholders of this information before they cast their votes on the plan. Moreover, once the debtor emerges from chapter 11, the court does not actively oversee the operations of the postconfirmation entity. Rather, at most, the court will entertain disputes arising from the operation of the postconfirmation entity if stakeholders request such review and the court has retained jurisdiction under the plan confirmation order. Some of the Commissioners noted that stakeholders frequently do not have the information, or access to the information, necessary to contest the decisions or operation of the postconfirmation entity.

The Commission considered recommending statutory guidelines for any postconfirmation entities. Nevertheless, as the Commissioners started to consider the elements of those guidelines, they quickly determined that a one-size-fits-all rule was not workable in this context and likely would create more litigation than efficiencies. They further determined that an important element underlying the potential problems with postconfirmation entities was disclosure. Parties need to understand, and have an opportunity to assess, the material terms of the postconfirmation entity and the trust or other applicable organizational documents. The Commissioners also noted that these disclosures were just as relevant and useful with respect to the reorganized debtor proposing to continue operations postconfirmation.

Accordingly, the Commission recommended amending section 1125 of the Bankruptcy Code to require specific disclosures concerning: (i) the governance (*e.g.*, individuals or entities managing the entity's affairs, general decision-making process, procedures for changing key personnel and voting protocols, equity security holders' or beneficiaries' rights with respect to governance matters, etc.) and assets of the reorganized debtor or other postconfirmation entity; (ii) the details of the claims and interests dispute, reconciliation, and distribution process; and (iii) the process to raise issues with the court concerning the postconfirmation entity or the implementation of the chapter 11 plan. It also voted to recommend that a debtor or plan proponent be permitted to use a postconfirmation entity, including a litigation trust, only if the court finds, based on the evidence presented at the confirmation hearing, that the entity and its organizational documents provide sufficient protections and procedures for creditors and other beneficiaries relying on the entity for their recoveries in the case.

Disclosure and Role of Claims Trading

Claims trading is often identified as a driving force behind the changing chapter 11 landscape. Harvey Miller has posited:

Claims trading has dramatically changed the dynamics of the reorganization process. Distressed debt traders have different motivations and objectives than the old line

those for previous insider misconduct and mismanagement of the debtor. Thus, the statute was in furtherance of the purpose of preserving all assets of the estate while facilitating confirmation of a plan.") (quoting *Duvoisin v. East Tenn. Equity, Ltd. (In re S. Indus. Banking Corp.)*, 59 B.R. 638 (Bankr. E.D. Tenn. 1986).

relationship banks and trade creditors. Quick and significant return on investment is the imperative to the traders.⁸⁷⁷

Other commentators disagree with this characterization, citing benefits to claims trading such as enhanced liquidity and cost savings associated with quicker case resolutions.⁸⁷⁸ The Commissioners likewise expressed varying positions on the value of claims trading, but they all recognized its increasing presence and arguable influence in chapter 11 cases.

The Commissioners discussed both whether increased regulation or increased disclosure would mitigate perceived problems with claims trading and add or help preserve value in chapter 11 cases. The Commission reviewed the changes to Bankruptcy Rule 3001(e) in 1991 and Bankruptcy Rule 2019 in 2011. These two rule changes arguably move in different directions on the issue of claims trading.

Bankruptcy Rule 3001(e) governs the transfer of claims. Specifically, it addresses the mechanics of filing and preserving transferred claims, depending on the timing of the transfer and the kind of claim transferred. The comments to the 1991 amendment to Bankruptcy Rule 3001(e) suggest that it was intended “to limit the court’s role to the adjudication of disputes regarding transfers of claims.”⁸⁷⁹ For example, unlike its predecessor, Bankruptcy Rule 3001(e)(1) does not require the transferor to acknowledge the transfer or to disclose the consideration exchanged in the transfer.⁸⁸⁰ The amendments to Bankruptcy Rule 2019, on the other hand, increase the disclosure obligations of certain investors acting collectively in the case. Although not targeted at claims traders *per se*, investors actively engaged in claims trading and potentially taking positions in, or trying to influence, the chapter 11 case are within its scope.

The Commissioners acknowledged the conflicting anecdotal evidence on claims trading and its impact on chapter 11 cases. Some witnesses argued for increased disclosures and restrictions on claims trading itself.⁸⁸¹ Others testified in favor of claims trading.⁸⁸² For example, Professor Edith Hotchkiss explained that her “own and other academic research has shown that this consolidation of claims is associated with more oversight of the process and more efficient reorganizations, evidenced

877 Harvey Miller, *Chapter 11 in Transition: From Boom to Bust and Into the Future*, 81 Am. Bankr. L. J. 375, 390 (2007).

878 See, e.g., *Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the value of the distressed debt market for debtors), available at Commission website, *supra* note 55. See also *supra* note 872.

879 See Advisory Committee Notes accompanying 1991 Amendment to Bankruptcy Rule 3001(e).

880 See, e.g., *Preston Trucking Co., Inc. v. Liquidity Solutions, Inc.* (In re Preston Trucking Co., Inc.), 333 B.R. 315 (Bankr. D. Md. 2005), *aff’d*, 392 B.R. 623 (D. Md. 2008) (finding that court cannot review transfer of claim for insufficient consideration).

881 *Written Statement of Jonathan C. Lipson: AIRA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–5 (June 7, 2013) (arguing for more disclosures regarding who holds the debtor’s debt and what other positions they might have), available at Commission website, *supra* note 55; *Oral Testimony of Michael R. (“Buzz”) Rochelle: UT Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 27–28 (Nov. 22, 2013) (UT Transcript) (stating that the ability of creditors to sell their debt to claims traders can undermine the bankruptcy case), available at Commission website, *supra* note 55.

882 See *Oral Testimony of Professor Anthony J. Casey: CFRP Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 44–45 (Nov. 7, 2013) (CFRP Transcript) (stating that claims trading is a positive development in bankruptcy), available at Commission website, *supra* note 55; *Written Statement of the Honorable Edith H. Jones, Fifth Circuit Court of Appeals: VALCON Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–3 (Feb. 21, 2013) (claims trading improves liquidity and reduces risk for traditional lenders), available at Commission website, *supra* note 55; *Oral Testimony of Jennifer Taylor: ABI WLC Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 24 (Nov. 30, 2012) (ABI WLC Transcript) (suggesting that transparency and disclosure in the claims trading market would likely have a significant negative impact on the secondary debt market), available at Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing liquidity offered by distressed debt markets), available at Commission website, *supra* note 55; *Written Statement of Jennifer Taylor: WLC Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Nov. 30, 2012) (describing the value of the distressed debt market for debtors), available at Commission website, *supra* note 55; *Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), available at Commission website, *supra* note 55.

by a greater likelihood of out-of-court restructurings or prepackaged bankruptcies, less time spent in reorganizations, and a greater likelihood that the firm continues as a going concern.”⁸⁸³

The Commission agreed that a robust secondary market exists for claims trading and that this market enhances liquidity opportunities for both debtors and creditors: it provides an exit strategy for creditors, which can induce credit extensions to potentially distressed companies in the first instance. As such, the Commissioners generally perceived little benefit to increased regulation of claims trading activities. They did, however, debate whether increased disclosure requirements could benefit parties in the chapter 11 case and those traded on the secondary markets. They considered, for example, extending the Bankruptcy Rule 2019 disclosures to all creditors, perhaps limited to those filing pleadings in connection with a section 363 sale, a plan, a postpetition financing facility, or a motion to appoint a trustee or examiner. The Commissioners examined the purpose and use of any additional disclosures by claims traders in the case. Many of the Commissioners believed that in many circumstances, what an investor paid for a claim or why it purchased the claim would be irrelevant to the merits or substantive legal issues in a dispute in the case. These Commissioners further noted that when price or motive may matter, courts already have means to determine and sanction inappropriate conduct through the claims subordination and vote designation processes.

On balance, the Commission found nominal value to these additional disclosures. The Commission also rejected any specific restrictions on claims trading or the participation of claims traders in chapter 11 cases, particularly in light of the Commission’s recommended clarification to vote designation under section 1126(e) of the Bankruptcy Code.

E. General Plan Content

1. Default Plan Treatment Provisions

Recommended Principles:

- A debtor or plan proponent should not be permitted to provide in its chapter 11 plan that, if a class of claims or interests does not vote on the plan, such class is deemed to have accepted the plan for all purposes.
- A debtor or plan proponent should be able to provide default treatment in the chapter 11 plan for any executory contracts and unexpired leases not specifically assumed or rejected under the Bankruptcy Code. If the chapter 11 plan does not provide such default treatment, executory contracts and unexpired leases not otherwise assumed or rejected under section 365 or, for collective bargaining agreements, section 1113 should be permitted to “ride through” the chapter 11 case and be unaffected by the section 1141 discharge. Section 1123 should be amended to implement this change.

⁸⁸³ Oral Testimony of Professor Edith Hotchkiss: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 35 (Oct. 17, 2012) (LSTA Transcript), available at Commission website, *supra* note 55.

Default Plan Treatment Provisions: Background

A chapter 11 plan may include provisions that specify the treatment under the plan of certain actions or nonactions by the debtor or other parties. Two common provisions include: (i) a statement that classes of creditors or interest holders not voting on the plan are deemed to accept the plan; and (ii) either the assumption or rejection of executory contracts and unexpired leases not otherwise assumed or rejected prior to the confirmation of the plan. These provisions enable a debtor or plan proponent to articulate bright-line rules for areas of uncertainty under the Bankruptcy Code and applicable law, but the permissibility and consequences of the provisions are less clear.

Section 1129(a)(8) of the Bankruptcy Code requires that each class of claims or interests accept the plan or remain unimpaired under the plan in order for the debtor or plan proponent to obtain confirmation. In addition, under sections 1129(a)(10) and 1129(b) as currently written, a debtor or plan proponent can seek to cram down a plan on objecting creditors and interest-holders only if, among other things, at least one impaired class of claims has accepted the plan. A debtor or plan proponent thus may include a provision in the plan purporting to treat classes of claims or interests that do not vote on the plan as accepting the plan. This situation may arise when creditors or equity security holders in the class simply do not submit ballots indicating acceptance or rejection of the plan.

Section 1126(c) of the Bankruptcy Code states that a class of claims or interest-holders accepts a plan if two-thirds in amount and a majority in number of those voting submit votes in favor of the plan.⁸⁸⁴ Bankruptcy Rule 3018(c) provides in relevant part that “acceptance or rejection [of the plan] shall be in writing, identify the plan or plans accepted or rejected, be signed by the creditor or equity security holder or an authorized agent, and conform to the appropriate Official Form.”⁸⁸⁵ Notably, the courts are split as to whether these provisions permit the plan to deem creditor silence as acceptance of the plan. For example, courts in the Second, Third, and Tenth Circuits tend to follow the Tenth Circuit’s decision in *Ruti-Sweetwater*, in which the court held that inaction by a single-creditor class with respect to the plan could be treated as an acceptance for purposes of section 1129(a)(8).⁸⁸⁶ Other courts have rejected the *Ruti-Sweetwater* approach, highlighting that the Bankruptcy Code expressly addresses “deemed acceptance” and permits it only in the case of unimpaired classes.⁸⁸⁷

Similar uncertainty exists in the context of executory contracts and unexpired leases not expressly assumed, assigned, or rejected by the trustee⁸⁸⁸ prior to plan confirmation. Section 365(d)(2) provides that the trustee may assume, assign, or reject executory contracts and some kinds of unexpired leases “at

⁸⁸⁴ 11 U.S.C. § 1126(c).

⁸⁸⁵ Fed. R. Bankr. P. 3018(c).

⁸⁸⁶ *Heins v. Ruti-Sweetwater, Inc.* (*In re Ruti-Sweetwater, Inc.*), 836 F.2d 1263 (10th Cir. 1988). “The general rule is that the acceptance of the plan by a secured creditor can be inferred by the absence of an objection.” *In re Szostek*, 886 F.2d 1405, 1413 (3d Cir. 1989). See also *In re Accuride Corp.*, 2010 WL 5093173, at *6 (Bankr. D. Del. Feb. 18, 2010); *In re DBSD N. Am., Inc.*, 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff’d*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff’d in part, rev’d in part*, 627 F.3d 496 (2d Cir. 2010); *In re Adelphia Commc’ns Corp.*, 368 B.R. 140 (Bankr. S.D.N.Y. 2007), *appeal dismissed, stay vacated*, 2007 WL 7706743 (2d Cir. Feb. 9, 2007).

⁸⁸⁷ See, e.g., *In re M. Long Arabians*, 103 B.R. 211, 216 (B.A.P. 9th Cir. 1989); *In re Vita Corp.*, 380 B.R. 525, 528 (C.D. Ill. 2008); *In re Castaneda*, 2009 WL 3756569 (Bankr. S.D. Tex. Nov. 2, 2009); *In re Jim Beck, Inc.*, 207 B.R. 1010, 1015 (Bankr. W.D. Va. 1997), *aff’d*, 214 B.R. 305 (W.D. Va. 1997), *aff’d*, 162 F.3d 1155 (4th Cir. 1998); *In re Higgins Slacks Co.*, 178 B.R. 853, 855 (Bankr. N.D. Ala. 1995); *In re Adkisson Vill. Apts. of Bradley Cty., Ltd.*, 133 B.R. 923 (Bankr. S.D. Ohio 1991); *In re Townco Realty, Inc.*, 81 B.R. 707, 708 (Bankr. S.D. Fla. 1987).

⁸⁸⁸ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

any time before the confirmation of a plan.”⁸⁸⁹ Unlike in the chapter 7 context,⁸⁹⁰ however, the Bankruptcy Code does not state what happens in the chapter 11 context to contracts or leases not assumed or rejected prior to confirmation, other than with respect to nonresidential real property leases.⁸⁹¹

In many cases, a debtor or plan proponent will include a default provision that provides for the deemed assumption or rejection of executory contracts or unexpired leases not otherwise expressly assumed or rejected prior to confirmation. If the plan is silent, however, the question arises whether such contracts and leases can “ride through” the chapter 11 case and remain enforceable postconfirmation. Under the ride-through doctrine, “executory contracts that are neither affirmatively assumed or rejected by the debtor under § 365, pass through bankruptcy unaffected.”⁸⁹² Many courts considering the issue have endorsed the ride-through doctrine,⁸⁹³ finding it consistent both with the permissive language of section 365(a) (*i.e.*, a trustee may assume or reject executory contracts and unexpired leases) and the revesting of estate property in the debtor postconfirmation under section 1141(b).⁸⁹⁴ Nevertheless, the Bankruptcy Code does not expressly authorize the ride-through doctrine. It also can create unexpected consequences for the reorganized debtor and the counterparty, including ongoing performance obligations for the debtor and a loss of rights in the chapter 11 case for the counterparty.⁸⁹⁵

Default Plan Treatment Provisions: Recommendations and Findings

The Commissioners discussed the cost of uncertainty in the plan-confirmation context. Such uncertainty can not only slow down plan negotiations, but it can also impact the prospective business of the reorganized debtor operating, at least in part, under the terms of the confirmed plan. In this context, the Commissioners discussed the appropriate treatment of (i) classes of claims and interests that are entitled to vote on the plan but take no action; and (ii) executory contracts and unexpired leases not otherwise assumed or rejected in the chapter 11 case.

The Commission reviewed the split in the courts regarding the ability to deem silence as acceptance for purposes of section 1129(a)(8) and (a)(10) and section 1129(b). Many of the Commissioners found the reasoning of courts rejecting the Tenth Circuit’s approach in *Ruti-Sweetwater* persuasive. These Commissioners noted that Congress knew how to provide for deemed acceptance, as evidence in the unimpaired claim context. Section 1126(e) states: “Notwithstanding any other provision of this section, a class that is not impaired under a plan, and each holder of a claim or interest of

⁸⁸⁹ 11 U.S.C. § 365(d)(2).

⁸⁹⁰ Section 365(d)(1) provides: “In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected.” 11 U.S.C. § 365(d)(1).

⁸⁹¹ Under section 365(d)(4), a trustee has 120 days, plus potentially one 90-day extension, to assume, assign, or reject unexpired leases on nonresidential real property. If the trustee fails to act, such leases are deemed rejected. 11 U.S.C. § 365(d)(4).

⁸⁹² *In re Hernandez*, 287 B.R. 795, 799 (Bankr. D. Ariz. 2002). See also *In re Polysat, Inc.*, 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993).

⁸⁹³ See, e.g., *Stumpf v. McGee (In re O’Connor)*, 258 F.3d 392, 404 (5th Cir. 2001); *Bos. Post Rd. Ltd. P’ship v. FDIC (In re Bos. Post Road Ltd. P’ship)*, 21 F.3d 477, 484 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995); *Pub. Serv. Co. of N.H. v. N.H. Elec. Coop., Inc. (In re Public Serv. Co. of N.H.)*, 884 F.2d 11, 14–15 (1st Cir. 1989).

⁸⁹⁴ Section 1141(b) provides: “Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.” 11 U.S.C. § 1141(b).

⁸⁹⁵ See, e.g., *In re Greystone III Joint Venture*, 995 F.2d 1274 (5th Cir. 1992), *cert. denied*, 506 U.S. 821 (1992), *cert. denied*, 506 U.S. 822 (1992) (holding that a nondebtor party to a contract riding through bankruptcy case has no claim against the estate and thus no right to vote on plan); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1352 (9th Cir. 1983), *superseded by statute*, Bankruptcy Code, as recognized by *In re Sturgis Iron & Metal Co., Inc.*, 420 B.R. 716, 726 n. 23, 737 n. 44 (Bankr. W.D. Mich. 2009) (holding that executory contract not otherwise assumed or rejected “continues in effect and the nonbankrupt party . . . is not a creditor with a provable claim against the bankrupt estate”).

such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required.”⁸⁹⁶ Other Commissioners emphasized the policy considerations articulated by the Tenth Circuit and courts following *Ruti-Sweetwater*: “To hold otherwise would be to endorse the proposition that a creditor may sit idly by, not participate in any manner in the formulation and adoption of a chapter 11 plan and thereafter, subsequent to the adoption of the plan, raise a challenge to the plan for the first time.”⁸⁹⁷ These courts also observe that treating inaction as rejection makes the deadlines for rejecting a plan or filing objections meaningless.⁸⁹⁸

In considering the competing issues on silence as deemed acceptance, the Commissioners discussed reasons why creditors may not vote. These reasons could include that the creditor is unfamiliar with the bankruptcy process or uninformed regarding the consequences of voting or not voting, the creditor may make a cost-benefit decision to abstain from voting, the creditor may be agnostic about the overall plan, the creditor may not like contingencies associated with an affirmative vote on the plan (such as a consent to a release), or the creditor may inadvertently fail to timely submit a ballot. The Commissioners did not necessarily believe that creditors should be deemed to accept a plan in all of these circumstances. Moreover, the Commissioners found it impracticable to suggest a case-by-case or creditor-by-creditor analysis in these situations. Accordingly, the Commission agreed that the better rule is to prohibit a plan from providing for “deemed acceptance” if an impaired class of claims fails to vote on a plan. The Commissioners also noted that the import of deemed acceptance would be reduced under these principles, given the Commission’s recommendations to eliminate the need for an accepting impaired class for cramdown purposes and the introduction of redemption option value into the cramdown analysis.⁸⁹⁹

The Commission also considered the most appropriate treatment for executory contracts and unexpired leases that are not otherwise assumed or rejected prior to confirmation in accordance with section 365(d)(2). The Commissioners commented that this issue most often arises by surprise — at or after confirmation, the reorganized debtor discovers an executory contract or unexpired lease, or the counterparty finally comes to discover the debtor’s chapter 11 case, and the parties are trying to deal with the impact, if any, of the debtor’s chapter 11 case on that contractual relationship. The Commissioners articulated the different approaches for handling these situations. For example, the Bankruptcy Code could provide that all executory contracts and unexpired leases not otherwise assumed or rejected by confirmation are deemed rejected. Alternatively, the Bankruptcy Code could provide for deemed assumption in such cases. The Commissioners noted that, under either of those default rules, the rule could produce significant unintended consequences for the debtor or the counterparty. In particular, deemed rejection could result in the debtor or counterparty unknowingly losing rights and access to products, services, or receivables necessary to the reorganized business. Accordingly, the Commission agreed that the better default rule was the ride-through doctrine, which is consistent with how nonexecutory contracts are treated and would preserve the parties’

⁸⁹⁶ 11 U.S.C. § 1126(f). See also 7 Collier on Bankruptcy ¶ 1126.04 (suggesting that the holding in *Ruti-Sweetwater* was incorrect).

⁸⁹⁷ *Heins v. Ruti-Sweetwater, Inc.* (*In re Ruti-Sweetwater, Inc.*), 836 F.2d 1263, 1266 (10th Cir. 1988).

⁸⁹⁸ *Id.* at 1266–67. See also *In re Adelphia Commc’ns Corp.*, 368 B.R. 140, 216–62 (Bankr. S.D.N.Y. 2007), *appeal dismissed, stay vacated*, 2007 WL 7706743 (2d Cir. Feb. 9, 2007) (“Regarding nonvoters as rejecters runs contrary to the [Bankruptcy] Code’s fundamental principle, and the language of section 1126(c), that only those actually voting be counted in determining whether a class has met the requirements, in number and amount, for acceptance or rejection of a plan, and subjects those who care about the case to burdens (or worse) based on the inaction and disinterest of others.”).

⁸⁹⁹ See Section VI.F.1, *Class Acceptance Generally and for Cramdown Purposes*; Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

rights, whatever those may be, for further negotiation. In addition, the Commission agreed that the Bankruptcy Code should expressly allow the debtor or plan proponent to alter this default rule and specifically provide for deemed assumption or rejection in its particular case.

2. Exculpatory Clauses

Recommended Principles:

- A debtor or plan proponent should be permitted to include an exculpatory clause in the chapter 11 plan that covers parties participating in the chapter 11 case and identified in the chapter 11 plan, including estate representatives, subject to customary exclusions consistent with public policy, that provides for exculpation with respect to acts or omissions during the case and prior to the effective date of the plan, including in connection with the negotiation, drafting, and solicitation of the plan. Confirmation of the chapter 11 plan under section 1129 should also include the approval and authorization of such permissible exculpatory clauses, provided that adequate disclosure of the scope of, and parties covered by, the exculpatory clause is included in the disclosure statement and the plan. Sections 1125(e) and 1129 should be amended accordingly.

Exculpatory Clauses: Background

A chapter 11 plan is in many respects a contract between the debtor or the plan proponent and the debtor's stakeholders. As in other contractual settings, courts have permitted parties to include provisions that exculpate the debtor's directors, officers, similar managing persons, and professionals; the unsecured creditors' committee and its professionals; and certain other parties with respect to conduct occurring during the chapter 11 case and prior to the effective date of the plan. Notably, exculpatory clauses differ from estate or third-party releases that may also be included in a chapter 11 plan. (Third-party releases are discussed below.) A release generally is a relinquishment of claims and causes of action that the debtor or third parties may have against certain nondebtor parties. An exculpatory clause is more akin to limited immunity for the identified parties for conduct during the chapter 11 case.

The Bankruptcy Code does not specifically address the inclusion of exculpatory clauses in chapter 11 plans. Nevertheless, courts tend to approve exculpation when it is reasonable considering the specific circumstances of the case.⁹⁰⁰ For example, one court has held that exculpatory clauses are more likely to be reasonable when the conduct covered has already occurred, the exculpatory clause was clearly contained in the plan, and parties entitled to vote have accepted the plan.⁹⁰¹ Another court has found an

900 See, e.g., *Unsecured Creditors' Comm. v. Pelofsky (In re Thermadyne Holdings Corp.)*, 283 B.R. 749, 755–56 (B.A.P. 8th Cir. 2002) (noting there is no *per se* rule that indemnification and exculpation provisions are impermissible under section 328(a) and holding that the provisions were unreasonable in this particular case); *In re Metricom, Inc.*, 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (holding that indemnity and exculpation provisions must be reasonable under the circumstances and “such a determination can only be made on a case by case basis”). See also *In re Comdisco, Inc.*, 2002 WL 31109431 (N.D. Ill. 2002); *In re DEC Int'l, Inc.*, 282 B.R. 423 (W.D. Wis. 2002); *In re Friedman's, Inc.*, 356 B.R. 758, 762 (Bankr. S.D. Ga. 2005) (citing *United Artists Theatre Co. v. Walton*, 315 F.3d 217 (3d Cir. 2003)). For a more complete discussion and additional case citations, see Kurt F. Gwynne, *Indemnification and Exculpation of Professional Persons in Bankruptcy Cases*, 10 Am. Bankr. Inst. L. Rev. 711 (2002).

901 *In re Friedman's, Inc.*, 356 B.R. 758, 761–63 (Bankr. S.D. Ga. 2005).

exculpatory clause reasonable when it was narrowly tailored, exculpated only negligent conduct, and was in the best interests of the estate.⁹⁰² Nevertheless, some courts have rejected exculpatory clauses outright, particularly in the context of professionals retained during the bankruptcy case.⁹⁰³

A typical exculpatory clause may protect the debtor's directors, officers, employees, advisors, and professionals from "incur[ring] any liability to any holder of a Claim or Equity Interest for any act or omission in connection with, related to, or arising out of, the Chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan or the Administration of the Plan or the property to be distributed under the Plan, except for willful misconduct or gross negligence."⁹⁰⁴ Courts generally find that exculpatory clauses fall outside the scope of section 524(e),⁹⁰⁵ which limits the reach of the bankruptcy discharge.⁹⁰⁶ They also frequently focus on the policy justifications underlying exculpation, including encouraging parties to engage in the process and assist the debtor in achieving a confirmable plan — actions that committees, committee members, other estate representatives and their professionals, and certain parties (such as key lenders) may not be willing to undertake in the face of litigation risk. As one court observed: "Exculpation provisions are frequently included in chapter 11 plans, because stakeholders all too often blame others for failure to get the recoveries they desire; seek vengeance against other parties; or simply wish to second-guess the decision makers in the chapter 11 case."⁹⁰⁷

Exculpatory Clauses: Recommendations and Findings

The Commission holistically reviewed the issues of discharge, releases, and exculpation. The Commissioners viewed exculpation as a targeted provision intended to protect good faith actors with respect to their conduct during the chapter 11 case. They generally agreed with those courts interpreting exculpatory clauses as establishing acceptable (or nonactionable) standards of conduct and not as affecting a waiver of, or injunction against, third-party claims. The Commissioners thus perceived a distinct difference between the contractual standards of conduct and limited immunity of exculpatory clauses and the more encompassing waivers often proposed by third-party releases. Although the Commission agreed that both types of provisions might be permissible in appropriate cases if certain factors were satisfied, it determined that different standards of review were warranted.

The Commission reviewed the potential parties and types of conduct that should be covered by exculpatory clauses. The Commission agreed that estate representatives (e.g., the debtor in possession, a trustee, an estate neutral, unsecured creditors' committees, committee members) and their professionals should be included within exculpatory clauses. It also acknowledged that the facts of particular cases might support the inclusion of other parties who actively engaged in the reorganization or plan process and could be the target of litigation by claimants unhappy with, among other things, the results of the

902 *Upstream Energy Servs. v. Enron Corp. (In re Enron Corp.)*, 326 B.R. 497, 504 (S.D.N.Y. 2005).

903 *In re Drexel Burnham Lambert Grp., Inc.*, 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) ("Simply stated, indemnification agreements are inappropriate") (citing *In re Realty Trust*, 123 B.R. 626, 630–31 (Bankr. C.D. Cal. 1991)). See generally Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7, Sept. 2011 (general review of case law addressing exculpatory clauses).

904 *In re PWS Holding Corp.*, 228 F.3d 224, 246 (3d Cir. 2000), *aff'd* 1999 WL 33510165 (Bankr. D. Del. Dec. 30, 1999).

905 Section 524(e) provides: "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e).

906 See *id.* (explaining that exculpation "does not affect the liability of these parties, but rather states the standard of liability under the Code"). See also *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 227 (2d Cir. 2005).

907 *In re DBSD N. Am., Inc.*, 419 B.R. 179, 217 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

chapter 11 case or their recoveries under the plan. The Commissioners debated objective factors to determine whether a party sufficiently contributed to the process to be included in the exculpatory clause, but determined that a fact-intensive analysis would work best. They also emphasized that this limited immunity was not intended to protect bad actors, but rather to protect only those parties who act in good faith and who should be protected against claims relating to matters that should be resolved once the plan is confirmed and becomes effective.

The Commissioners discussed whether exculpatory clauses should protect the identified parties from simple negligence or something more. The Commission determined that immunity for conduct arguably constituting simple negligence should be subject to exculpation. It was not able to agree on the desirability of allowing exculpation for gross negligence or other standards of conduct, but believed that the parties and the court should make such decisions based on the facts of the case and public policy considerations. The Commission voted to recommend amendments to the Bankruptcy Code to clarify the permissibility of exculpatory clauses consistent with these principles and properly disclosed in the disclosure statement and plan.

3. Third-Party Releases

Recommended Principles:

- A debtor or plan proponent should be permitted to seek approval of third-party releases in connection with the solicitation and confirmation of the chapter 11 plan. Such third-party releases should be clearly and conspicuously highlighted and explained in the plan and the disclosure statement, identifying the proposed scope of, and parties to be covered by, the releases. The court should approve any such third-party releases based on evidence presented at the hearing and in accordance with the factors set forth below.
- In reviewing a proposed third-party release included in a chapter 11 plan, the court should consider and balance each of the following factors: (i) the identity of interests between the debtor and the third party, including any indemnity relationship, and the impact on the estate of allowing continued claims against the third party; (ii) any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan; (iii) the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts; (iv) the level of creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release. In a case involving the application of third-party releases to creditors and interest-holders not voting in favor of the plan, the court should give significant weight to the last of these factors.
- A proposed release of a debtor's affiliates in the chapter 11 plan should be subject to the same review and approval process proposed above for general third-party releases in these principles.

Third-Party Releases: Background

A confirmed chapter 11 plan “discharges the debtor from any debt that arose before the date of such confirmation.”⁹⁰⁸ The discharge voids any judgments, and enjoins collection and similar actions, asserting personal liability against the debtor based on debts discharged under the plan.⁹⁰⁹ Section 524(e) also provides that “[a] discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.”⁹¹⁰ Courts and plan proponents often grapple with the scope and application of this limitation under section 524(e) in the context of third-party releases included in a chapter 11 plan. The Bankruptcy Code recognizes an exception to this limitation for debtors establishing trusts for asbestos claimants; in those cases, the court may enter an order enjoining actions against nondebtor parties.⁹¹¹

A release provision in a chapter 11 plan essentially relieves the identified nondebtor parties of any liability for any claims or causes of actions that third parties might hold against them. In a chapter 11 plan, a release may seek to cover the debtor’s directors and officers, an unsecured creditors’ committee and its members, a nondebtor plan proponent, a plan sponsor, the debtor’s lenders and their agents, and other parties who may have been actively engaged in the chapter 11 case and perhaps made contributions to the process.⁹¹² The release may encompass any and all claims or causes of action, or resulting liability, of these nondebtor parties. The release may be binding on only those third parties who consent to the release or who vote in favor of (or abstain from voting on) the plan and the release; it may also be binding on all third parties if the release is approved in connection with confirmation of the plan.⁹¹³

Some commentators assert that section 524(e) prohibits all third-party releases, regardless of their scope or the parties purportedly bound by the provision. Two circuits, the Ninth and the Tenth, have adopted this strict view of third-party releases.⁹¹⁴ Specifically, the Ninth Circuit has stated: “The bankruptcy court lacks the power to confirm plans of reorganization which do not comply with the

908 11 U.S.C. § 1141(d)(1)(A).

909 *Id.* § 524(a). Specifically, section 524(a) provides that a discharge “voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived.” *Id.*

910 11 U.S.C. § 524(e).

911 11 U.S.C. § 524(g). See generally *Written Statement of Professor S. Todd Brown, SUNY Buffalo Law School Before the ABI Comm’n to Study the Reform of Chapter 11* (Nov. 7, 2013) (discussing issues related to resolution of asbestos claims), available at Commission website, *supra* note 55.

912 Nondebtor releases for insiders such as officers and directors may be subject to more rigorous scrutiny, in part because “[t]hose who benefit from this type of release are most likely the ones asserting that the debtor will be irreparably harmed without it.” Elizabeth Gamble, *Nondebtor Releases in Chapter 11 Reorganizations: A Limited Power*, 38 *Fordham Urb. L.J.* 821, 840 (2011) (analogizing to *Spach v. Bryant*, 309 F.2d 886 (5th Cir. 1962) and noting that bankruptcy court must apply “careful attention and special scrutiny when the claimants are officers, directors or stockholders of the corporate bankrupt”). See also *Hopper v. Am. Nat’l Bank of Cheyenne, Wyo.* (*In re Smith-Chadderdon Buick, Inc.*), 309 F.2d 244, 247 (10th Cir. 1962) (“A claim presented by an officer or director of the bankrupt is subjected to rigorous scrutiny and the claimant must prove good faith and fairness in the transaction”).

913 “[T]he provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan.” 11 U.S.C. § 1141(a). See also Sharon L. Levin et al., *The WaMu Lesson: Craft Your Release Carefully*, *Law360*, Jan. 28, 2011 (discussing rejection of releases in chapter 11 cases of *Washington Mutual Inc.* and *WMI Investment Corp.*).

914 See *Resorts Int’l, Inc. v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996) (holding that section 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors); *Am. Hardwoods, Inc. v. Deutsche Credit Corp.* (*In re Am. Hardwoods, Inc.*), 885 F.2d 621, 625 (9th Cir. 1989) (same); *Underhill v. Royal*, 769 F.2d 1426, 1432 (9th Cir. 1985) (“Section 524(e) precludes discharging the liabilities of nondebtors.”). See also *Landsing Diversified Props.-II v. First Nat’l Bank & Trust Co. of Tulsa* (*In re W. Real Estate Fund, Inc.*), 922 F.2d 592, 601 (10th Cir. 1990) (holding that nondebtor release “improperly insulate[s] nondebtors in violation of section 524(e)”), *modified*, *Abel v. West*, 932 F.2d 898 (10th Cir. 1991).

applicable provisions of the Bankruptcy Code. . . . This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors.⁹¹⁵ The Ninth Circuit has, however, recognized that nondebtor releases may be permitted in asbestos claims cases pursuant to specific statutory authority.⁹¹⁶ The Fifth Circuit also appears to be more restrictive than permissive with respect to third-party releases.⁹¹⁷

The other circuits that have considered the issue focus instead on section 105(a) of the Bankruptcy Code, which gives the court authority to “issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code].”⁹¹⁸ These courts are willing to consider and approve third-party releases under appropriate circumstances. To make this determination, these courts undertake a fact-intensive inquiry analyzing factors such as any contractual or consensual basis for the releases, the role and contributions of the nondebtor parties in the chapter 11 case, the protections afforded by the plan for third parties bound by the releases, and whether the releases are necessary for the debtor’s effective reorganization.⁹¹⁹

Courts adopting a permissive approach to third-party releases do not find section 524(e) as impermeable barrier.⁹²⁰ They generally point out that section 524(e) does not contain “language of prohibition” and thus should not be interpreted to limit the court’s power under section 105(a).⁹²¹ They also may distinguish the releases based on the facts of the given case, such as when the third

915 *Resorts Int’l, Inc. v. Lowenschuss* (*In re Lowenschuss*), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).

916 *Id.* at 1402, n. 6 (“The Bankruptcy Reform Act of 1994 added § 524(g) to the [Bankruptcy] Code. That section provides that in asbestos cases, if a series of limited conditions are met, an injunction issued in connection with a reorganization plan may preclude litigation against third parties.”).

917 The Fifth Circuit view on nondebtor third-party releases and exculpation clauses is less clear. In several cases, the court has rejected such third-party releases, particularly when such releases are nonconsensual. *See, e.g.*, *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm.* (*In re Pac. Lumber Co.*), 584 F.3d 229, 253 (5th Cir. 2009); *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 760 (5th Cir. 1995). However, some Fifth Circuit cases suggest that the court does not categorically disprove of such releases and may approve them in certain limited circumstances. *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm.* (*In re Pac. Lumber Co.*), 584 F.3d 229, 253 (5th Cir. 2009) (suggesting that nondebtor releases are “most appropriate as a method to channel mass claims toward a specific pool of assets”); *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 760 (5th Cir. 1995) (suggesting that a release may be approved where the third party nondebtor liability is not extinguished but instead channeled to a settlement fund). *But see* *Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V.* (*In re Vitro S.A.B. de C.V.*), 701 F.3d 1031, 1062 (5th Cir. 2012) (stating that “[the Fifth Circuit] has firmly pronounced opposition to [nonconsensual nondebtor] releases”). The Fifth Circuit’s decision in *Vitro* contains very strong language suggesting a complete prohibition on nonconsensual third-party releases. Nevertheless, even in *Vitro*, the Fifth Circuit acknowledges that specific, rather than general, third-party releases may be permissible under certain limited circumstances: “We have distinguished other cases for including general, as opposed to specific, releases. As a result, *Republic Supply Co.* provides no guidance where, as here, we are confronted not by a specific release, but by a general release of all the non-debtor subsidiaries.” *Id.* at 1068–69 (citations omitted). Accordingly, the Fifth Circuit appears to lean more toward the restrictive approach of the Ninth and Tenth Circuits but may not be as all-inclusive in its prohibition. In addition, the Fifth Circuit has actually approved of releases in some limited circumstances, although the court has utilized different statutory authorization to do so. *See, e.g.*, *Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm.* (*In re Pac. Lumber Co.*), 584 F.3d 229 (5th Cir. 2009) (using section 1103(c) to approve exculpation provisions for members of the creditors’ committee but rejecting other release provisions).

918 *See, e.g.*, *MacArthur Co. v. Johns-Manville Corp.* (*In re Johns-Manville Corp.*), 837 F.2d 89 (2d Cir. 1988), *cert. denied*, 488 U.S. 868 (1988) (noting that section 105(a) “has been construed liberally to enjoin suits that might impede the reorganization process”).

919 *Deutsche Bank AG v. Metromedia Fiber Network, Inc.* (*In re Metromedia Fiber Network, Inc.*), 416 F.3d 136, 142 (2d Cir. 2005) (“Courts have approved nondebtor releases when: the estate received substantial consideration; the enjoined claims were ‘channeled’ to a settlement fund rather than extinguished; the enjoined claims would indirectly impact the debtor’s reorganization ‘by way of indemnity or contribution’; and the plan otherwise provided for the full payment of the enjoined claims. Nondebtor releases may also be tolerated if the affected creditors consent.”) (citations omitted). “But this is not a matter of factors and prongs. No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique.” *Id.* *See also* *Gillman v. Cont’l Airlines* (*In re Cont’l Airlines*), 203 F.3d 203, 212 (3d Cir. 2000) (indicating that nondebtor releases may be appropriate in extraordinary cases); *Feld v. Zale Corp.* (*In re Zale Corp.*), 62 F.3d 746, 761–62 (5th Cir. 1995) (holding that nondebtor releases could be issued because case satisfied “unusual circumstances” requirement; released parties provided substantial consideration to the estate and the release was a key provision of the plan).

920 *See generally* Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7, Sept. 2011 (general review of case law addressing third-party releases).

921 *Monarch Life Ins. Co. v. Ropes & Gray*, 65 F.3d 973, 979 (1st Cir. 1995) (citations omitted).

party claims subject to the release are not extinguished, but channeled to allow recovery from separate assets, which commonly means the nondebtor did not receive a complete discharge.⁹²² Notably, some courts have held that the court's power under section 105(a) in the nondebtor release context should be exercised only when there are unique circumstances. The U.S. Supreme Court also has, in *dicta*, provided an additional factor to consider: whether the claims against the nondebtor third party are derivative of the debtor's wrongdoing.⁹²³

Third-Party Releases: Recommendations and Findings

The Commission considered this basic question: Should the Bankruptcy Code prohibit third-party releases in chapter 11 plans? The Commission agreed that a blanket prohibition on third-party releases was inadvisable. The Commissioners discussed case examples and particular fact patterns in which third-party releases facilitated a confirmable plan and ultimately benefited all stakeholders. They recognized, however, that third-party releases might not be appropriate in every chapter 11 case. For example, a release provision could be overly broad or not really necessary, particularly in cases where the benefits of the release to the estate are nominal, but the harm to creditors is significant. Accordingly, the Commission rejected carte blanche approval of third-party releases, as well as a presumption in favor of such releases.

The Commissioners discussed the competing considerations underlying the third-party release debate. A debtor may need the assistance of nondebtor parties to effect its reorganization. This assistance may be in the form of service, collaboration, funding, business commitments, or other means that allow the debtor to achieve its objectives in the chapter 11 case or in its postconfirmation operations. Nondebtor parties may be reluctant to contribute to the plan or the debtor's reorganization efforts if the nondebtor party might be exposed to liability or will have ongoing liability despite confirmation of the chapter 11 plan. On the other hand, limiting creditors' recoveries to those provided under the plan may substantially change the nature of their rights against nondebtor parties, and in turn further reduce their overall recoveries. In these instances, from the creditors' perspective, nondebtor parties may be receiving a windfall at the creditors' expense.

In light of these considerations, the Commission methodically worked through the various issues that arise in the context of third-party releases. The Commissioners started from the premise that consensual third-party releases — those releases binding only on creditors who expressly consent to the release through a vote on the plan that includes consent to the third-party release, a separate indication on the ballot that the creditor consents to the third-party release, or a separate agreement from the creditor in which it consents to the release — should be enforceable. The Commission disagreed with the Ninth and Tenth Circuits' position that contractual agreements between the affected parties regarding a third-party release should not be enforced. The Commissioners found these kinds of contractual agreements outside the scope of section 524(e) and consistent with the underlying policies of the Bankruptcy Code.

⁹²² *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 760–61 (5th Cir. 1995).

⁹²³ *Travelers Indemnity Co. v. Bailey*, 557 U.S. 137, 155 (2009) (“Our holding is narrow. We do not resolve whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing.”).

The Commissioners then reviewed the different kinds of nonconsensual third-party releases commonly included in chapter 11 plans. The Commissioners observed the challenges in crafting a bright-line test or general approval standard for such nonconsensual releases. They then considered the different tests used by courts to evaluate nonconsensual third-party releases. Specifically, the Commissioners analyzed the multi-factor tests used by the courts in the *Dow Corning* and the *Master Mortgage* cases, respectively. For example, the court in *Dow Corning* stated:

We hold that when the following seven factors are present, the bankruptcy court may enjoin a nonconsenting creditor's claims against a nondebtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The nondebtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.⁹²⁴

The court in *Master Mortgage* articulated a five-factor test that considers: (1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) whether the nondebtor has contributed substantial assets to the reorganization; (3) whether the injunction is essential to reorganization; (4) whether a substantial majority of the creditors agree to such injunction — specifically, whether the impacted class or classes have “overwhelmingly” voted to accept the proposed plan treatment; and (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.⁹²⁵

The Commission considered the application of each factor to different scenarios, including the relationship of the factors to nonconsensual releases. It agreed that in the context of nonconsenting creditors or classes of claims, the factors focusing on the contributions of nondebtor parties, percentage recoveries by the affected creditors, and mechanisms established to facilitate recoveries to those creditors were of particular importance, with specific emphasis on the last of these factors. On balance, the Commission recommended a standard based on the *Master Mortgage* factors and rejected application of the *Dow Corning* factors. It further determined that the *Master Mortgage* factors adequately captured the careful review required in these cases and declined to incorporate separate identification of unique or unusual circumstances.

⁹²⁴ *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002), cert. denied, 537 U.S. 816 (2002).

⁹²⁵ *In re Master Mortg. Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).

F. Plan Voting and Confirmation Issues

1. Class Acceptance Generally and for Cramdown Purposes

Recommended Principles:

- The numerosity requirement of section 1126(c) of the Bankruptcy Code should be replaced with a “one creditor, one vote” concept. Accordingly, a class of claims should be treated as voting in favor of the chapter 11 plan if the plan is accepted by: (i) creditors (other than an entity designated under section 1126(e)) holding at least two-thirds in amount of the allowed claims in such class; and (ii) more than one-half in number of the creditors (other than an entity designated under section 1126(e)) holding allowed claims in such class. For purposes of this requirement and voting on a plan, (a) a creditor holding separate claims in different capacities (e.g., as an indenture trustee and as an individual creditor) should be able to vote once in each capacity; and (b) the “one creditor, one vote” voting rule includes and aggregates all claims in a particular class held by an entity and its affiliates (as defined in section 101(2)) that are subject to common investment management.
- The confirmation of a chapter 11 plan should not require the acceptance of the plan by at least one class of claims impaired under the plan. Accordingly, section 1129(a)(10) should be deleted.

Class Acceptance Generally and for Cramdown Purposes: Background

In general, creditors whose rights are impaired by the chapter 11 plan are entitled to vote to accept or reject the plan.⁹²⁶ Although creditors vote on an individual basis, the plan typically groups claims into classes and proposes particular treatment (e.g., terms and amount of recoveries) for each class. Section 1122(a) provides that “a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.” Accordingly, a debtor or plan proponent attempts to group similarly situated creditors in the same class, though strategic considerations may complicate this analysis.

The classification of claims is important for at least two reasons. First, class acceptance determines creditor support for the plan. Specifically, section 1126(c) provides, “A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the

⁹²⁶ 11 U.S.C. § 1126(a), (f) (subsection (a) establishes general rights of holders of claims and interests to vote on plan; subsection (f) provides that unimpaired classes “and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required”).

allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan.” Second, the debtor or plan proponent generally needs at least one accepting impaired class of creditors to cram down the plan under section 1129(b).

The two requirements of section 1126(c) — *i.e.*, two-thirds in amount and more than one-half in number of allowed claims — set the minimum support required for the class as a whole to accept the plan. If the class accepts and the plan is confirmed, even creditors in the class who voted against the plan, or abstained from voting, are bound by the plan. As such, the level of approval required for class acceptance is often heavily scrutinized and contested. Of the two requirements, the numerosity requirement (more than one-half in number of allowed claims) is the more difficult to interpret and apply in many cases. For example, under appropriate circumstances, a single creditor may exercise more than one vote so long as the court determines that the claims are sufficiently “separate” to warrant more than one vote.⁹²⁷ The determination of sufficient separateness is based on whether the claims in question derive from independent underlying transactions with the debtor, and whether separate proofs of claim were, or will be, filed for the claims.⁹²⁸ Notably, this determination may resolve whether the class accepts or rejects the plan.⁹²⁹

Similarly, the requirement that one impaired class of creditors accepts the plan under section 1129(a)(10) may prevent a debtor or plan proponent from confirming a plan under the cramdown provisions of section 1129(b). Although some courts and commentators suggest that section 1129(a)(10) was intended to ensure that a plan had some creditor support, neither the legislative history nor the Bankruptcy Code indicate such a purpose.⁹³⁰ Notably, given the variation in class composition and the different motives and objectives of creditors, a non-accepting class does not necessarily equate to lack of creditor support for the plan. Some commentators have questioned the section’s continued utility in light of the barriers to confirmation and the creditor holdup value it creates in many chapter 11 cases.

927 *Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter Ltd.)*, 118 F.3d 635 (9th Cir. 1997), *cert. denied*, 522 U.S. 996 (1997); *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989). See also Wendell H. Adair, Jr. & Kristopher M. Hansen, *One Claim, One Vote: The Purchase of Claims to Avoid Cramdown*, J. CORP. RENEWAL, Jul. 1, 2000 (“Once again citing the voting formula contained in Section 1126(c) of the Bankruptcy Code, the court held that acceptance or rejection of a plan by a class of creditors is determined by ‘the number of claims, not the number of creditors, that actually vote for or against a plan.’”), available at <http://www.turnaround.org/Publications/Articles.aspx?objectID=1294>.

928 See, e.g., *In re Gilbert* 104 B.R. 206, 211 (Bankr. W.D. Mo. 1989). See also David M. Feldman & Keith R. Martorana, *The Pervasive Problem of Numerosity*, Law360, June 2, 2010, available at <http://www.gibsondunn.com/publications/Documents/Feldman-ThePervasiveProblemOfNumerosity.pdf>.

929 See *In re Kreider*, 2006 Bankr. LEXIS 2948 (Bankr. E.D. Pa. Sept. 27, 2006). In *Kreider*, the creditor class consisted of four American Express funds and five completely unrelated entities; the five unrelated entities voted to accept the plan and the four American Express funds voted to reject the plan. The court rejected the debtor’s calculation that the voting resulted in five votes in favor and one against the plan (counting the American Express funds as one vote against the plan). *Id.* at *8–9. The court explained: “[I]t appears that the Debtors’ unstated premise — *i.e.*, multiple claims voted by a single creditor are counted as a single vote for purpose of the ‘more than one-half in number of allowed claims’ requirement for acceptance of a plan set forth in 11 U.S.C. § 1126(c) — is simply incorrect.” *Id.* at *9.

930 See generally S. Rep. No. 95-989, at 128 (1978), *reprinted in* 1978 U.S.C.A.N. 5787, 5914 (stating that at least one class must accept the plan). See, e.g., Clark Boardman Callaghan & Randolph J. Hines, *Bankruptcy Review Commission Fails to Achieve Significant Chapter 11 Reform*, 8 Norton Bankr. L. Adviser 1, Aug. 1997 (“No case law or commentator has identified any important social or reorganization policy that [section 1129(a)(10)] serves. The historical genesis for the requirement reveals it to be a vestigial mutation that serves no evolutionary purpose.”); Scott F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 U. Kan. L. Rev. 507, 537–38 (1998) (noting that neither the legislative report to the 1978 version of the Bankruptcy Code nor 1984 revisions provide insights concerning the purpose of section 1129(a)(10)). Cf. *In re Windsor on the River Assocs., Ltd.*, 7 F.3d 127, 131 (8th Cir. 1993) (interpreting legislative history to suggest that the purpose of section 1129(a)(10) “is to provide some indicia of support by affected creditors and prevent confirmation where such support is lacking”).

Class Acceptance Generally and for Cramdown Purposes: Recommendations and Findings

The composition of a creditor class for plan purposes can significantly impact a chapter 11 case. A debtor or a plan proponent may consider whether classes can be structured to isolate or dwarf dissenting creditors, or to ensure that creditors supporting the plan dominate the class. Likewise, creditors seeking to delay or disrupt confirmation can raise questions concerning why certain creditors were, or were not, included in a particular class; they also can diversify or strategically purchase claims so that they hold blocking positions in one or more classes. In sum, claims classification and voting under section 1122 and 1126 are subject to significant gamesmanship.⁹³¹

The Commissioners discussed the distraction and diversion of resources caused by this gamesmanship. The Commissioners noted that the original purpose of classification was to provide equal treatment for similarly situated creditors. Likewise, the dollar amount and numerosity requirements of section 1126(c) were intended to protect minority holders. Nevertheless, some of the Commissioners observed that changes in debtors' capital structures and the dynamics of chapter 11 cases arguably decreased the relevance of these objectives. In particular, these Commissioners asserted that a nexus no longer exists between minority protection and the numerosity requirement. A class dominated by smaller claims may face an apathy problem, in which inaction by creditors fails to give any creditor a meaningful voice in the vote.⁹³² The consolidation of claims by creditors eliminates the "small" or typical minority holder in many cases. In addition, strategic purchases by the same or affiliated entities of "separate" claims can skew the counting for purposes of numerosity.

The anecdotal evidence that the numerosity requirement served, at best, a nominal role in determining class support for a plan persuaded the Commissioners. They considered various alternatives to the numerosity requirement, including the elimination of the voting requirement completely, maintaining the *status quo*, distinguishing among types of creditors (e.g., financial instrument holders and all others), and introducing additional disclosures to address the perceived empty voting problem, as discussed in Section VI.F.2, *Assignment of Voting Rights*. In discussing the alternatives, the Commissioners found the "one creditor, one vote" rule most democratic and less susceptible to abuse than the current numerosity requirement. Although identifying the "one creditor" for purposes of this requirement may still raise issues, the Commissioners believed that these concerns could be mitigated by treating all affiliated entities under common investment management as a single creditor, and expressly recognizing the different capacities (e.g., indenture trustee and lender) in which a single creditor may hold claims. The Commissioners emphasized

931 The Commission heard testimony in favor of clarifying the section 1122(a) standard for classification of "substantially similar" claims. See, e.g., *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 14 (Nov. 15, 2012) ("While the Bankruptcy Code mandates that similarly situated creditors be classified for plan purposes in substantially similar classes, the Code offers no guidance as to how to determine which claims are in fact 'substantially similar.' As a result, creditors in general, and secured creditors in particular, do not often get the benefit of their contractual bargain with the debtor. Indeed, it is the debtor who, in the first instance, makes the economic determination of the creditors' rights when it comes to classification of claims based upon the specific prepetition contractual agreements with the debtor, rather than merely whether the claim is secured or unsecured. All too often, factors come into play in determining classification of claims that should be irrelevant, such as motivation of the parties, purchase price and third-party rights."), available at Commission website, *supra* note 55.

932 Wendell H. Adair, Jr., Kristopher M. Hansen, *One Claim, One Vote: The Purchase of Claims to Avoid Cramdown*, J. CORP. RENEWAL, Jul. 1, 2000 ("Once again citing the voting formula contained in Section 1126(c) of the Bankruptcy Code, the court held that acceptance or rejection of a plan by a class of creditors is determined by 'the number of claims, not the number of creditors, that actually vote for or against a plan.'"), available at <http://www.turnaround.org/Publications/Articles.aspx?objectID=1294>.

that the “common investment management” requirement for aggregation was intended to exclude situations in which affiliates are not only separate entities, but also have different decision-makers overseeing the claims being asserted against the estate. The Commission agreed that the “one creditor, one vote” rule should replace the current numerosity requirement in section 1126(c).

The Commission also considered the impediment to confirmation created by sections 1129(a)(10) and 1129(b), which require at least one accepting impaired class of creditors for the debtor or plan proponent to achieve confirmation through the cramdown provisions of the Bankruptcy Code.⁹³³ The Commissioners debated the utility of section 1129(a)(10), focusing on whether the provision protected creditor interests or simply allowed creditors to hold up the confirmation process. For example, the Commissioners discussed cases with a limited number of impaired creditor classes and a lender or other large creditor who purchases a sufficient number of claims in each class to control the plan vote. By voting against the plan in each of these classes, that single creditor can block a cramdown because there will be no accepting impaired class of creditors for purposes of section 1129(a)(10).

The Commissioners also highlighted issues raised by artificial impairment, in which the debtor or plan proponent strategically grouped claims to achieve at least one accepting impaired class of creditors. Courts are split concerning whether the debtor or plan proponent can achieve impairment of a class through minor changes in the terms of the creditor’s claim or repayment rights or whether impairment follows only meaningful economic changes to the debt. For example, the Fifth Circuit (agreeing with the Ninth Circuit, but declining to follow the Eighth Circuit) held that artificial or minor impairment was sufficient for purposes of section 1129(a)(10).⁹³⁴ The Fifth Circuit noted that such an approach aligned with the policy of encouraging reorganization and that to hold otherwise would be to “shoehorn[] a motive inquiry and materiality requirement into section 1129(a)(10)” that did not exist.⁹³⁵ As noted by one well-respected commentator: “Congress apparently did not consider the impact of some creditors having more than one vote. [Bankruptcy] Code § 1129(a) (10) causes debtors to attempt to create friendly creditors, to impair creditor classes that need not be impaired and to manipulate classification systems.”⁹³⁶

The Commissioners acknowledged the potential gating role served by section 1129(a)(10) — ensuring that some creditors whose claims were impaired by the plan supported its confirmation. They discussed the validity of this inquiry and the integrity it potentially added to the confirmation process. They debated the advantages and disadvantages of retaining the requirement, particularly in light of the potential abuses of the section by both creditors and debtors. They considered alternatives, such as retaining section 1129(a)(10) on a per plan basis⁹³⁷ or only in single asset real estate cases.⁹³⁸

933 Written Statement of Daniel Kamensky on Behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11 (Oct. 17, 2012) (“Decisions such as this invite management manipulation of the classification rules for strategic purposes. This, in turn, creates uncertainty regarding creditor recovery and treatment under a plan. This is of particular concern for financial creditors.”).

934 W. Real Estate Equities, L.L.C. v. Vill. at Camp Bowie I, L.P. (*In re Vill. at Camp Bowie I*, L.P.), 710 F.3d 239 (5th Cir. 2013).

935 *Id.*

936 Norton Bankr. L. & Prac. 3d § 113:10 (Jan. 2013).

937 In *Tribune*, the court held that section 1129(a)(10) required an impaired creditor class of each debtor in the corporate organization to vote for the plan instead of a single impaired creditor class across the corporate organization (*i.e.*, among all affiliated debtors) in the joint plan. *In re Tribune Co.*, 464 B.R. 126 (Bankr. D. Del. 2011). Prior cases had held that in a joint plan only one accepting class in a joint plan was required. *See, e.g.*, JPMorgan Chase Bank, N.A. v. Charter Commc’ns Operating, LLC (*In re Charter Commc’ns*), 419 B.R. 221 (Bankr. S.D.N.Y. 2009), *aff’d*, 691 F.3d 476 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 2021 (2013).

938 The Commission reviewed the application of section 1129(a)(10) in single asset real estate cases and agreed with the advisory committee that, on balance, the section was an impediment to confirmation and subject to significant abuse. Both the

Ultimately, the Commission determined that the potential delay, cost, gamesmanship, and value destruction attendant to section 1129(a)(10) in all cases significantly outweighed its presumptive gating role. The Commission recommended eliminating section 1129(a)(10) in its entirety from the Bankruptcy Code.

2. Assignment of Voting Rights

Recommended Principles:

- The contractual assignment or waiver of voting rights in favor of senior creditors under an intercreditor, subordination, or similar agreement should not be enforced. Subordinated creditors should retain the right to vote on a plan (or their right to be deemed to have done so under section 1126(g) of the Bankruptcy Code) and to invoke the protections of section 1129(b).
- The contractual assignment of voting rights in favor of an assignee or purchaser of a claim against the estate should be enforced only to the extent of the portion of the claim and economic interest also transferred to the assignee or purchaser. For purposes of this principle, the holder of a claim should be the party entitled to exercise the voting rights assigned or associated with the claim.

Assignment of Voting Rights: Background

Creditors may enter into subordination agreements or intercreditor agreements prior to the debtor filing its chapter 11 case. These agreements commonly address the priority of payment as between the creditors from the proceeds of shared collateral. These agreements also may address certain other matters relating to the debtor and the collateral. For example, they may limit the junior creditors' rights to (i) request adequate payment; (ii) offer or participate in postpetition financing for the debtor; (iii) foreclose on the collateral; or (iv) vote on a chapter 11 plan in any chapter 11 case. The last of these provisions may be accomplished through a waiver or assignment of the voting right or underlying claim for voting purposes. Assignments of voting rights also occur between parties outside of the subordination and intercreditor agreement context.

The assignment or waiver of voting rights raises several issues under the Bankruptcy Code. Section 510(a) of the Bankruptcy Code speaks to the enforceability of a prepetition subordination agreement, providing that “[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy. [law]”⁹³⁹ Courts generally enforce the payment terms of subordination agreements, to the extent that the agreement is otherwise enforceable under state law. Some courts question, however, whether creditors should be permitted to affect or waive specific bankruptcy rights prior to, or in anticipation of, a bankruptcy filing.⁹⁴⁰

Commission and the advisory committee supported its elimination in single asset real estate cases.

⁹³⁹ 11 U.S.C. § 510(c).

⁹⁴⁰ Sharon L. Levine et al., *If You Assign Your Plan Vote — Mean It*, Law360, July 9, 2013, 5:35 p.m. (discussing recent trends in the enforcement of assignment provisions under subordination agreements). See also Edward Rust Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 Ill. L. Rev. __, at *11 (forthcoming 2015) (suggesting that waivers and assignments in an

Courts that have declined to enforce assignments or waivers of voting rights in a chapter 11 case focus on the voting provisions of section 1126 and emphasize that the section permits a “holder of a claim . . . under section 502 of this title [to] accept or reject a plan.”⁹⁴¹ These courts underscore that the junior creditors are the holders of the claim and that, in turn, only those creditors may exercise the right to vote on the debtor’s chapter 11 plan.⁹⁴² Courts also question the ability of parties generally to waive rights created by, and only available in a case under, federal bankruptcy laws.⁹⁴³

Other courts have enforced voting assignment or waiver provisions in subordination agreements.⁹⁴⁴ These courts read section 1126(c) more broadly, noting that it does not prohibit the delegation of rights associated with claims held by a creditor. They also rely on the expressed language of section 510(c) and Bankruptcy Rules 3018 and 9010 and emphasize that the only qualification to enforcement of subordination agreements is that the agreements be enforceable under state law. As one court explained, the Bankruptcy Rules “explicitly permit agents and other representatives to take actions, including voting, on behalf of other parties.”⁹⁴⁵

Another issue that arises in the context of voting or claim assignments in chapter 11 cases is whether the assignment decouples the economic and voting rights. This kind of decoupling — sometimes referred to as the “empty creditor problem” — may change the interests or objectives of the party actually exercising the vote. A party with no economic risk or stake in the chapter 11 estate may not be a similarly situated creditor with others in the voting class. Similar concerns exist with a party holding disproportionate voting and economic interests. Although the empty creditor problem is typically discussed in the context of credit default swaps,⁹⁴⁶ it also can arise in a simple claim or voting assignment agreement.

Assignment of Voting Rights: Recommendations and Findings

The Commission’s deliberations on assignments and waivers of voting rights focused largely on two policy considerations: respecting the private contract rights of nondebtor parties and fostering the underlying goals of chapter 11.⁹⁴⁷ The Commissioners observed that a simple response would be to endorse freedom of contract principles among nondebtor parties. The Commission agreed, however, that this response oversimplified the dilemma and was unsatisfactory in several respects. The core issue concerns the impact that private ordering among nondebtor parties may have on the debtor, the estate, and other stakeholders in the chapter 11 case.

intercreditor agreement should only be enforced if it is “unlikely to affect the outcome of the Chapter 11 process (sale versus reorganization, or confirmation of one plan versus another) and primarily to affect the distributions of parties to the agreement.”) (draft on file with Commission). See generally Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. Penn. J. Bus. L. 35 (2009) (discussing claims assignment in bankruptcy generally).

941 11 U.S.C. § 1126(a).

942 See, e.g., *In re* 203 N. LaSalle St. P’ship, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

943 *In re* Hart Ski Mfg. Co., Inc., 5 B.R. 734 (Bankr. D. Minn. 1980).

944 See, e.g., *Blue Ridge Investors II, LP v. Wachovia Bank, N.A.* (*In re* Aerosol Packaging, LLC), 362 B.R. 43, 45–47 (Bankr. N.D. Ga. 2006).

945 *Id.*

946 See, e.g., Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications*, 14 Eur. Fin. Mgmt. 663, 680 (2008) (“Debt decoupling involving the unbundling of the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization. Corporations can have empty and hidden creditors, just as they can have empty and hidden shareholders.”); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625, 728–35 (2008).

947 Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11 (Oct. 17, 2012) (“Specifically, lenders and investors must have confidence in their ability to realize upon their investment in the event of a bankruptcy. This includes reliance on the enforcement of contracts, applicable state and federal legal rights, including enforcement of lien priority, and the absolute priority rule.”).

The Commissioners discussed the potential impact of voting assignments on the chapter 11 case. They evaluated situations in which senior creditors influence the plan structure or control the vote on the plan through the assignment provision.⁹⁴⁸ Such conduct can affect valuations of the debtor's assets, the debtor's postconfirmation operations and capital structure, and the value ultimately available for distributions to other stakeholders.⁹⁴⁹ The Commissioners generally were uncomfortable with nondebtor parties being able to change, arguably in very substantive ways, the rights of the debtor and other stakeholders in the chapter 11 case.

The Commissioners also evaluated the classification and voting provisions of the Bankruptcy Code. Many of the Commissioners agreed with courts that have held that section 1126(a) is relevant to the enforceability of voting assignments. Although the section does not address delegation of rights, the reference to "holder of the claim" suggests some nexus between the vote and the holder of the legal right to payment on the claim. They recognized the language of section 510(c), which expressly permits the enforceability of subordination agreements. Many of the Commissioners noted, however, that the provisions included in subordination and intercreditor agreements have significantly expanded beyond the mere ordering of payment among nondebtor parties.⁹⁵⁰ The Commission thus considered whether prohibiting voting assignments would significantly affect the payment priority agreed to by the parties under the subordination agreement. Some of the Commissioners argued that allowing junior creditors to vote on the plan may give those creditors bargaining power or control over the plan process, as they would have incentive to increase distributions to their class to provide for repayment of the senior debt and some value for the junior debt. On balance, the Commission found that preserving the agreed-to payment priority was the crucial element of subordination agreements, and that prohibiting assignments or waivers of voting rights would not disturb such a feature.

The Commissioners also identified and discussed many of the same concerns with partial claim assignments and voting assignments outside the subordination agreement context. The Commission determined that requiring economic and voting rights (in whole or in part) to be transferred as a package was aligned with the relevant sections of the Bankruptcy Code and mitigated to some extent the empty creditor problem. The Commission also agreed that the holder of the assigned claim should be entitled to exercise any transferred voting rights and may agree to exercise its vote as directed by the beneficial owner (e.g., a bond held in street name is held by a broker, but voted as directed by the account-holder, a holder of a claim that is subject to a participation interest may vote as directed by the participant). The Commissioners recognized that simply requiring transfers of voting and economic rights in the same proportion would not necessarily remedy those situations in which a creditor has hedged its economic losses in the chapter 11 case through a derivative or swap product. Nevertheless, the Commission determined that any potential issues in that context could be best resolved by the court on a case-by-case basis under the new principles addressing designation of votes under section 1126(e).

948 See Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940, at *7–8 (noting that intercreditor agreements "reduce decisionmaking costs in the event of default, but also give senior lenders power to exploit subordinated creditors and potentially other investors in the firm").

949 Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940 (discussing *In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011), in which the secured creditor which was party to an intercreditor agreement ultimately only raised the cost of cramming down a chapter 11 plan that had been accepted by all other classes and which offered full repayment of the secured creditor's claims).

950 See generally Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940 (noting that some intercreditor agreement provisions (which may provide that certain creditors waive their rights to object to DIP financing or the sale or use of collateral, to seek adequate protection, or to vote on the plan (by assigning their voting rights to senior creditors)) reorder the Bankruptcy Code's bargaining environment).

3. Designation of Votes

Recommended Principles:

- The court should be permitted to designate a party's vote in one or more classes under section 1126(e) of the Bankruptcy Code based on evidence presented at the hearing that such party voted in a manner manifestly adverse to the economic interests of the other creditors in the class or did not act in good faith.

Designation of Votes: Background

Section 1126(e) of the Bankruptcy Code allows a court to disqualify a vote on a chapter 11 plan if such vote was not obtained in good faith.⁹⁵¹ Specifically, section 1126(e) provides that, “[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith or was not solicited or procured in good faith or in accordance with the provisions of this title.”⁹⁵² The party seeking designation bears the burden of proof, and this burden has been described as being a “heavy” one.⁹⁵³

Courts have disallowed votes under section 1126(e) on the grounds of bad faith when, for example, the claimholder attempts to extract or extort a personal advantage not available to other creditors in its class, the creditor has an “ulterior motive” such as to procure some collateral or competitive advantage that does not relate to its claim, or the motivation behind the vote is not consistent with a creditor’s protection of its self-interest as a creditor.⁹⁵⁴ “[B]adges of the requisite bad faith include creditor votes designed to (1) assume control of the debtor, (2) put the debtor out of business or otherwise gain a competitive advantage, (3) destroy the debtor out of pure malice or (4) obtain benefits available under a private agreement with a third party that depends on the debtor’s failure to reorganize.”⁹⁵⁵ Courts generally agree that self-interest alone is not sufficient to designate a vote under section 1126(e).⁹⁵⁶

Designation of Votes: Recommendations and Findings

Some commentators have expressed concerns regarding conflicts of interest that may influence a creditor’s conduct, including its vote on a plan, in a chapter 11 case. Such conflicts of interest may include holding claims in multiple classes under the plan, holding interests in competitors of the debtor, having a business agenda that conflicts with the debtor’s reorganization, or having nominal economic exposure compared to other creditors in the class because of private agreements or a hedging strategy. The Commission determined that section 1126(e) was the most effective means to address these concerns.

⁹⁵¹ 11 U.S.C. § 1126(e).

⁹⁵² *Id.*

⁹⁵³ See, e.g., *In re Adelpia Commc’ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (“The party seeking to have a ballot disallowed has a heavy burden of proof.”).

⁹⁵⁴ See, e.g., *In re Dune Deck Owners Corp.*, 175 B.R. 839 (Bankr. S.D.N.Y. 1995); *In re Kovalchick*, 175 B.R. 863, 875 (Bankr. E.D. Pa. 1994).

⁹⁵⁵ *In re Adelpia Commc’ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).

⁹⁵⁶ *Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter Ltd.)*, 118 F.3d 635, 639 (9th Cir. 1997), *cert. denied*, 522 U.S. 996 (1997).

The Commission agreed that holding interests potentially in conflict with the interests of the debtor or other creditors in the voting class should not automatically disqualify a creditor from participating in the case or voting on the chapter 11 plan. Likewise, considering these interests and voting in the creditor's self-interest should not necessarily warrant designation. The Commissioners acknowledged, however, that at some point self-interested conduct by a creditor holding interests adverse to the debtor or other creditors in the class should result in the creditor losing its voting rights in the case.

The Commissioners examined different standards for designating votes and factors relevant to those determinations. For example, the Bankruptcy Code could permit a creditor to vote only in the class representing the holder's predominant economic interest in the case. It could allow the court to designate the holder's vote (including in all classes) if the creditor voted in a manner that was manifestly against the interest of the general holders of claims in that class. Alternatively, it could specifically adopt the "ulterior motive" standard used by some courts under the current version of section 1126(e).

In reviewing these alternatives, the Commissioners started from the basic premise that creditors should be able to vote in their own interests, and that the mere existence of a potential conflict in holdings should not warrant designation. They debated whether section 1126(e) and existing case law adequately address cases in which a creditor votes in a manner intended to delay or disrupt the case, or to disadvantage the treatment of a particular class. The Commission agreed that section 1126(e) arguably allows for remedies in these instances, but many of the Commissioners believed that courts are reluctant to extend the section to these and similar scenarios. These Commissioners argued for a stronger directive in section 1126(e) to guide courts in making these determinations.

The Commissioners vetted both the "ulterior motive" standard and one in which courts would focus on whether the conduct or vote was manifestly adverse to other creditors in the class. Some of the Commissioners asserted that the ulterior motive standard was too ambiguous and may not capture cases involving conflicts of interest that cause a creditor to vote adversely to the general interests of creditors in the class — *e.g.*, a creditor who holds a conflict or potential conflict of interest and is the only creditor in the class voting against the plan. Such conduct may not be bad faith or necessarily rise to the level of ulterior motive, but it may objectively be sufficiently harmful that designation is warranted. In this regard, many Commissioners observed significant overlap between the ulterior motive standard and the general bad faith inquiry.⁹⁵⁷ On balance, the Commission agreed that section 1126(e) should be amended to permit courts to consider both whether the creditor's vote was "manifestly adverse" to the interests of the general creditors in the class or was cast in bad faith. This hybrid standard would preserve creditor autonomy, but also provide courts with statutory authority to protect the estate and general creditors when a class vote has been infected by a creditor's conflict of interest.

⁹⁵⁷ For a thoughtful exploration of the grounds for vote designation in chapter 11, see Christopher W. Frost, *Bankruptcy Voting and the Designation Power*, 87 Am. Bankr. L.J. 155 (2013) (discussing the policy and use of claims designation under the case law and recommending certain parameters for designation).

4. Settlements and Compromises in Plan

Recommended Principles:

- In confirming a chapter 11 plan under section 1129 of the Bankruptcy Code, the court should evaluate any settlements and compromises incorporated into the plan under the standard proposed for codification in these principles and grant or deny approval of any such settlements and compromises in the confirmation order under section 1129. This requirement should include any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. Accordingly, section 1129(a) should be amended to add a new provision that requires the court to find, based on evidence presented by the debtor or plan proponent at the hearing, that each settlement or compromise incorporated into the plan is reasonable and in the best interests of the estate.
- For the recommended principles on codifying the review standard, see Section V.G, *Standard for Reviewing Settlements and Compromises*.

Settlements and Compromises in Plan: Background

A chapter 11 plan in many respects embodies a series of compromises between the debtor and its creditors to resolve the debtor's financial distress and allow the debtor to emerge from bankruptcy. Indeed, the heart of the plan is typically the proposed treatment of creditors' claims, which often compromises creditors' rights, and creditors accept or reject this proposed compromise by voting on the plan. A chapter 11 plan can also, however, include more substantive settlements or compromises that do not necessarily relate to the claims allowance process, but do have a material role to play in the debtor's emergence from chapter 11. Outside the plan process, these kinds of settlements and compromises would require separate notice and approval by the court, under Bankruptcy Rule 9019, which these principles propose be codified with certain modifications.⁹⁵⁸

Courts employ different approaches to reviewing settlements and compromises incorporated into a chapter 11 plan. Some courts evaluate the settlement or compromise as part of the plan confirmation process under section 1129, without necessarily requiring separate evidence to support the appropriateness of the agreement. These courts in some respects treat creditors' votes on the plan as sufficient for approving or scrutinizing the terms of settlements contained in the plan, including those not involving claims-resolution matters. Other courts require separate motions under Bankruptcy Rule 9019, or at least separate evidence on the proposed settlement in connection with the confirmation hearing. These courts often distinguish settlements involving claims or causes of action held by the estate from those concerning claims against the estate and wrapped up in the claims allowance process. They generally will require some separate consideration of the former, but handle the latter under the section 1129(a) factors.

⁹⁵⁸ See Section V.G, *Standard for Reviewing Settlements and Compromises*.

Settlements and Compromises in Plan: Recommendations and Findings

Settlements and compromises in chapter 11 cases may affect a debtor's chapter 11 plan indirectly or directly. A settlement proposed prior to the filing of a chapter 11 plan might indirectly affect the plan by dictating the flow of funds for creditors' recoveries under the plan.⁹⁵⁹ Parties may challenge these kinds of preplan settlements as inappropriate *sub rosa* plans — *i.e.*, disguised plans that are not being subjected to the scrutiny of the plan confirmation process under section 1129.⁹⁶⁰ A settlement also may directly affect a chapter 11 plan if it is incorporated into the plan or is a prerequisite to the plan.

The Commission analyzed the interplay between settlements and plans. The Commissioners discussed the facts of the *Iridium* decision and preplan settlements as potential workarounds of the absolute priority rule of section 1129(b).⁹⁶¹ They observed that these issues are largely mitigated if the settlement is considered in connection with plan confirmation, but they realized that this process forces the issue of whether settlements require separate approval. Some of the Commissioners asserted that the vote on the plan should be sufficient, but others argued that the minority should not be bound by unfavorable compromises. The Commissioners also noted that plan settlements often are not linked to class treatment, so that creditors may not appreciate the terms or import of the settlement in casting their votes.

The Commissioners wrestled with how to identify settlements and compromises that should be subject to separate approval from those integrated into the claims allowance process and addressed by creditors' votes and related provisions in section 1129. The Commission generally agreed that the court should separately approve any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. After weighing the advantages and disadvantages of various approaches, the Commission recommended requiring separate consideration of all settlements and compromises included in, or proposed in connection with, a chapter 11 plan under the "reasonable and in the best interests of the estate" standard recommended for settlements and compromises outside of the plan process under these principles. Notably, the Commissioners did not vote to require a separate motion or hearing on plan-related settlements and compromises. Rather, the Commission agreed that section 1129(a) should be amended to require that the court specifically find that all settlements and compromises included in, or related to, the plan are "reasonable and in the best interests of the estate" as part of the confirmation process.

959 See, e.g., *United States v. AWECO, Inc. (In re AWECO, Inc.)*, 725 F.2d 293, 298 (5th Cir. 1984), *cert. denied*, 469 U.S. 880 (1984) ("[A] bankruptcy court abuses its discretion in approving a [preplan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors"). Cf. *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 464 (2d Cir. 2007) (rejecting AWECO test as "too rigid" and not "accommodate[ing] the dynamic status of some preplan bankruptcy settlements"); *In re World Health Alternatives, Inc.*, 344 B.R. 291, 298 (Bankr. D. Del. 2006) (holding that absolute priority rule is not relevant to approval of preplan settlements).

960 See Craig A. Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37, 51 (1999).

961 *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452 (2d Cir. 2007).

5. Discharge of Claims upon Confirmation

Recommended Principles:

- Except as provided in section 1141(d)(2) and (d)(3) of the Bankruptcy Code and except as otherwise provided in the chapter 11 plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan should be free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor, including any interests, liens, or claims that would be removed from the debtor's assets in the context of a section 363x sale under the recommended principles for section 363(f). Section 1141(c) should be amended accordingly. *See* Section V.B.3, *Transactions Free and Clear of Interests*.

Discharge of Claims upon Confirmation: Background

Confirmation of a plan binds the debtor, its creditors, and its interest-holders to the terms of the plan.⁹⁶² These parties generally may receive distributions on account of their prepetition claims and interests only in accordance with the plan, and a business debtor that reorganizes is otherwise discharged from these claims and interests.⁹⁶³ Moreover, under section 1141(c) of the Bankruptcy Code, property dealt with under the plan is free and clear of all such claims and interests.

The language of section 1141(c) is broad, covering “all claims and interests of creditors, equity security holders, and of general partners in the debtor.”⁹⁶⁴ Yet, some courts have limited its application, particularly in the successor liability context.⁹⁶⁵ These courts acknowledge the language of the statute, but also raise due process and notice concerns.⁹⁶⁶ The uncertainty surrounding a debtor's ability to transfer property free and clear of all claims and interests can increase transaction costs, generate litigation, and limit the utility of the property in the hands of the reorganized debtor. It also may impede a debtor's ability to reorganize, or may affect its restructuring options in chapter 11.

Discharge of Claims upon Confirmation: Recommendations and Findings

Throughout their deliberations, the Commissioners were focused on, among other things, reducing costs in chapter 11, increasing efficiencies, and helping facilitate the restructuring of viable businesses. To that end, the Commission decided to clarify and broaden the kinds of interests, liens, and claims subject to a debtor in possession's ability to sell assets free and clear under section 363(f) of the Bankruptcy Code. In so doing, the Commission recommended a principle that provides, “In the

⁹⁶² 11 U.S.C. § 1141(a).

⁹⁶³ *Id.* § 1141(d).

⁹⁶⁴ *Id.* § 1141(c). *See also* George M. Treister et al., *Fundamentals of Bankruptcy* 425 (7th ed. 2010) (“Congress in Chapter 11 intended that the confirmed plan would . . . discharg[e] all obligations to creditors, whether or not the creditors participated in the reorganization process.”).

⁹⁶⁵ For a thorough examination of successor liability law, see George W. Kuney, *A Taxonomy and Evaluation of Successor Liability*, 6 Fla. St. Bus. L. Rev. 9 (2007).

⁹⁶⁶ *See, e.g.,* Kewanee Boiler Corp. v. Smith (*In re Kewanee Boiler Corp.*), 198 B.R. 519, 540 (Bankr. N.D. Ill. 1996) (explaining that “enjoining [the tort victim's] efforts to liquidate his claim against the reorganized debtor and forcing him to partake in [the] bankruptcy would be an inadmissible deprivation of his property interest in that claim, wholly without prior due process notice or bankruptcy notice”).

context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.”⁹⁶⁷ The Commission determined that a similar provision should govern property dealt with under a plan.

The Commissioners discussed the relevant policy considerations, and they believed that a chapter 11 plan should provide protection from claims as broad as that recommended by the Commission to be available in a section 363x sale. In addition, some Commissioners voiced concerns that treating these two situations differently could encourage a sale of the debtor’s assets even when reorganization was feasible or a better alternative for many of the debtor’s stakeholders. Although the Commission recommended principles to govern the sale of substantially all of a debtor’s assets under section 363x, the Commission agreed that such sales should not provide better or meaningfully different treatment for parties than the plan process. Accordingly, if a debtor in possession⁹⁶⁸ could sell assets free and clear of a particular claim under the recommended principles for section 363(f), a debtor or plan proponent also should be able to achieve a similar result under sections 1129 and 1141.

G. Orders Resolving Chapter 11 Case (Exit Orders)

Recommended Principles:

- The Bankruptcy Code should be amended to clarify that a chapter 11 case can be resolved only in the following three ways: (i) confirmation of a plan under section 1129; (ii) conversion of the case under section 1112; and (iii) dismissal of the case subject to section 349.

Orders Resolving Chapter 11 Case (Exit Orders): Background

In general, a debtor exits chapter 11 through a confirmation order, a dismissal order, or a conversion order. Section 1129 governs the entry of an order confirming a chapter 11 plan.⁹⁶⁹ Section 1112 generally provides that “on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or to dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause.”⁹⁷⁰ Section 305 permits a court to dismiss or suspend a case under the Bankruptcy Code if “the interests of creditors and the debtor would be better served by such dismissal or suspension.”⁹⁷¹ Moreover, section 349 addresses

⁹⁶⁷ See Section V.B.3, *Transactions Free and Clear of Interests*.

⁹⁶⁸ As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. See *supra* note 76 and accompanying text. See generally Section IV.A.1, *The Debtor in Possession Model*.

⁹⁶⁹ 11 U.S.C. § 1129.

⁹⁷⁰ *Id.* § 1112(b).

⁹⁷¹ *Id.* § 305(a).

the effect of a dismissal order and provides, among other things, that such an order reinstates certain liens and actions, vacates certain orders, and reverts property in its prepetition owner.⁹⁷²

The Bankruptcy Code's alternatives for ending a chapter 11 case are fairly straightforward. Nevertheless, courts have been confronting an exit strategy for chapter 11 debtors that does not necessarily fall within the traditional exit alternatives, commonly called a structured dismissal.⁹⁷³ A "**structured dismissal**" is a hybrid dismissal and confirmation order in that it typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third party-releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case. These additional provisions — often deemed "bells and whistles" — are usually the result of a negotiated and detailed settlement arrangement between the debtor and key stakeholders in the case.

Structured dismissals are subject to some controversy as a result of these bells and whistles. Opponents of structured dismissals argue that the Bankruptcy Code either does not authorize or expressly prohibits some of the provisions included in these dismissal orders.⁹⁷⁴ Proponents of structured dismissals, on the other hand, argue that the Bankruptcy Code does authorize the practice and note how practical and efficient structured dismissals can be in certain cases.

Some of the common features present in structured dismissal cases are noted below:

- Substantially all of the debtor's assets have been sold pursuant to a section 363 sale.
- The debtor's estate is essentially reduced to cash to be distributed.
- The secured creditors are undersecured and there are insufficient funds to pay the administrative claims associated with the case (the case is administratively insolvent).
- A detailed settlement agreement (or similar) that disposes of significant issues in the case has been approved by the court and may have been consummated.
- As a result of the settlement agreement (or similar), the proceeds of the sale of the debtor are transferred from the estate to the undersecured lender.
- There is an alternative claims-allowance process.
- There are third-party release provisions.
- A portion of the sale proceeds have been carved out to create a "gift" trust to benefit lower priority creditors, proceeds to which they would likely not be entitled in a chapter 11 plan.

⁹⁷² *Id.* § 349.

⁹⁷³ Although structured dismissals appear to be increasingly common, some cases suggest that structured dismissals are not a recent development. *See In re Buffet Partners, L.P.*, 2014 WL 3735804 (Bankr. N.D. Tex. July 28, 2014) ("On a smaller scale, structured dismissals occur regularly in this and other bankruptcy courts. Often the parties enter the case on the eve of foreclosure, work out their differences through a sale or giveback of property, and the parties enter an agreement submitted to this court for approval that results in the dismissal of the case."); *In re Aerospace & Indus. Mfg., Inc.*, 2008 WL 2705071 (Bankr. N.D. Tex. July 7, 2008) (dismissing case pursuant to a settlement agreement because dismissal will result "in a more favorable return to unsecured creditors . . . who otherwise risk receiving nothing in the case").

⁹⁷⁴ *See* 11 U.S.C. § 349(b).

- The court retains jurisdiction over the case after dismissal and all prior court orders survive the dismissal.

The debate regarding the authority of a court to issue an order approving a structured dismissal is grounded in the Bankruptcy Code. Parties on both sides of the debate agree that (i) the court is authorized to issue a “plain vanilla” case dismissal order for cause when in the best interests of creditors and the estate, and (ii) the Bankruptcy Code is silent regarding what a dismissal order may or may not contain. Proponents of structured dismissals focus on sections 1112(b) and 305(a) of the Bankruptcy Code as grounds for approving such dismissals. Opponents focus on the purpose of section 349⁹⁷⁵ and the general principle that section 305(a) is considered an extraordinary remedy because a court’s order under that section is not subject to review on appeal.⁹⁷⁶ Other Code sections and legislative history also are cited on both sides of the debate.

Orders Resolving Chapter 11 Case (Exit Orders): Recommendations and Findings

Anecdotal evidence suggests that the increasing use of structured dismissals is linked directly to the rise in sales of all or substantially of a debtor’s assets under section 363 and outside of the plan process. Parties may request a structured dismissal because of the actual or perceived costs and delays associated with the plan-confirmation process or a conversion to chapter 7 of the Bankruptcy Code. Parties also may resist a conversion because of the automatic appointment of a trustee and the subordination of unpaid administrative claims in the chapter 11 case to the administrative claims incurred by the chapter 7 trustee.

The Commissioners acknowledged that courts are approving structured dismissals to try to facilitate efficient case resolutions. Some of the Commissioners supported the use of structured dismissals when no other alternative is available to monetize the debtor’s assets for the benefit of at least some creditors. Other Commissioners observed that there are always alternatives — *e.g.*, a sale followed by a clean section 1112/349 dismissal order, a sale followed by conversion to chapter 7, a sale in chapter 7, a sale after a clean dismissal under state law. These Commissioners noted that a lack of alternatives was not the issue; rather, it really was driven by the desire of the purchaser, debtor, or other key stakeholder to sell the assets free and clear under section 363(b) and (f) of the Bankruptcy Code quickly, plus to get some of the benefits of a confirmation order without complying with the disclosure and soliciting provisions of the confirmation process.

⁹⁷⁵ See, *e.g.*, H.R. Rep. No. 95-595 (1977), reprinted in 1978 U.S.C.C.A.N. 5787, 6294 (“The basic purpose of [section 349] is to undo the bankruptcy case as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case.”). See also *Armel Laminates, Inc. v. Lomas & Nettleton Co.* (*In re Income Prop. Builders, Inc.*), 699 F.2d 963, 965 (9th Cir. 1982) (“11 U.S.C. § 349, treating the effects of a bankruptcy, obviously contemplates that on dismissal a bankrupt is reinvested with the estate, subject to all encumbrances which existed prior to the bankruptcy. After an order of dismissal, the debtor’s debts and property are subject to the general laws, unaffected by bankruptcy concepts. After dismissal a debtor may file another petition for bankruptcy unless the initial petition was dismissed with prejudice.”); *Citizens First Nat’l Bank of Princeton v. Rumbold & Kuhn, Inc.* (*In re Newton*), 64 B.R. 790, 793 (Bankr. C.D. Ill. 1986) (“[T]o the extent possible a dismissal of a petition reverses what has transpired during a bankruptcy.”); *In re Safren*, 65 B.R. 566, 571 (Bankr. C.D. Cal. 1986) (“The objective of section 349(b) is to restore all property rights, insofar as is practicable, to their positions when the case was filed.”).

⁹⁷⁶ See, *e.g.*, *In re Monitor Single Lift I Ltd.*, 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) (“Granting an abstention motion pursuant to § 305(a)(1) requires more than a simple balancing of harm to the debtor and its creditors; rather, the interests of both the debtor and its creditors must be served by granting the requested relief.”).

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The Commissioners debated the advantages and disadvantages of structured dismissals. The Commissioners generally believed that debtors should be able to sell all or substantially all of their assets under section 363(b) when that is the best and most efficient way to maximize value and potentially rehabilitate the business. They did not, however, endorse a process that short-circuits or completely eliminates creditor protections under the Bankruptcy Code. The Commissioners discussed certain components of structured dismissals that were particularly troubling in this respect, including provisions that violate the absolute priority rule,⁹⁷⁷ grant third-party releases,⁹⁷⁸ or deviate from the traditional claims-allowance process.⁹⁷⁹ As explained by the court in *LCI Holding Co.*:

The motion [requesting approval of a sale and dismissal order] attempts to restructure the rights of existing creditors and equity, without affording parties in interest the protections of a plan, disclosure statement and the confirmation solicitation process. . . . Were the Term Sheet presented as a plan, the Court would be required to approve a disclosure statement to be used to solicit votes from the impaired creditor classes. The Term Sheet raises multiple issues that a disclosure statement would address. These issues include claim resolution procedures, resolution of fee claims[, etc.]. . . . A disclosure statement would also have to address facts not disclosed in the motion, including but not limited to a budget, a liquidation analysis, and the existence of any additional assets.⁹⁸⁰

The Commissioners first considered whether provisions could be drafted that would facilitate some of the objectives of a structured dismissal, but that would not impede the rights of, and key protections for, creditors in the case. As the Commissioners started to carve out problematic provisions from an “acceptable” structured dismissal, they recognized that it likely was an unworkable solution. They bolstered this conclusion by reviewing the recommended principles for section 363x sales. Under these recommended principles, a sale of all or substantially all of a debtor’s assets will incorporate appropriate creditor protections from the confirmation process. If these protections are implemented, the court may approve the sale, and its order may include (i) a release or discharge to affect claims protection for the purchaser and (ii) certain specified distributions to priority creditors. The Commissioners believed that the recommended principles for section 363x sales should render the use of structured dismissals unnecessary.

Accordingly, the Commission recommended strict compliance with the Bankruptcy Code in terms of orders ending the chapter 11 case. Specifically, the Commission agreed that a court should be

⁹⁷⁷ See, e.g., *In re Jevic Holding Corp.*, No. 14-01465 (3d Cir. Aug. 14, 2014) [Docket No. 45] (citing *Begier v. I.R.S.*, 496 U.S. 53, 58 (1990)).

⁹⁷⁸ *In re Jevic Transp. Corp.*, No. 13-00104 (SLR) (D. Del. Jan. 24, 2014) [Docket No. 22]. Indeed, a structured dismissal may provide a broader third-party release than otherwise would be permissible in the chapter 11 case. For example, the release provision in *TLG Liquidation* is particularly notable:

The Debtors, for themselves and their estates, and the Committee, for itself and its members, representatives, agents, professionals, successor and assigns . . . release and forever discharge any and all Claims and Defenses against the Agent, each of the Lenders and their respective shareholders, partners, members, officers, directors, managing members, employees, representatives, agents, professionals, successors and assigns, from the beginning of time through the date the Approval Order becomes a final and nonappealable order.

In re TLG Liquidation Corp., No. 10-10206 (MFW) (Bankr. D. Del. Apr. 30, 2010) [Docket No. 275].

⁹⁷⁹ For example, in some cases, claims are allowed in the amounts submitted in the dismissal motion unless there is an objection. See *In re GI Joe Holding Corp.*, No. 09-10713 (KG) (Bankr. D. Del. Feb. 23, 2011) [Docket No. 746]; *In re Wickes Holdings LLC*, No. 08-10212 (Bankr. D. Del. May 12, 2009) [Docket No. 1418].

⁹⁸⁰ *In re LCI Holding Co.*, No. 12-13319 (KG) (Bankr. D. Del. May 21, 2013) [Docket No. 773].

permitted to confirm a plan under section 1129, convert a case under section 1112, or dismiss a case provided that the requested dismissal and the dismissal order satisfy the applicable provisions of, and do not permit the parties to work around, the Bankruptcy Code.

2022 ANNUAL SPRING MEETING

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VII. PROPOSED RECOMMENDATIONS: SMALL AND MEDIUM- SIZED ENTERPRISE (SME) CASES

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Most business bankruptcy cases filed in the United States involve small and middle-market enterprises. These businesses include family owned businesses, entrepreneurial ventures, and startup companies. They form the backbone of the American economy. As explained in one survey, “[a]ccording to the U.S. Economic Census, companies with 50 to 5,000 employees account for more employment than those with over 5,000.”⁹⁸¹ This survey also noted that “in terms of output, the sheer number of mid-market firms accounts for the fact that, in aggregate, their revenues surpass those of the top 100 U.S. companies by capitalization and are equivalent to roughly 40 percent of the U.S. GDP.”⁹⁸²

Nevertheless, small and middle-market enterprises are prone to preliminary setbacks and initial failures, and they can be among the hardest hit in economic downturns.⁹⁸³ The chart below from the Bureau of Labor Statistics generally indicates that among new businesses, approximately 50 percent of those businesses fail within the first five years of operation and approximately 70 percent fail before their tenth anniversary.⁹⁸⁴

981 Deloitte Development LLC, *Mid-Market Perspectives: America’s Economic Engine — Competing in Uncertain Times 4* (2011), available at http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_dges_competing_in_uncertain_times_09202011.pdf.

982 *Id.* See also *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1, 4 (Nov. 15, 2012) (“The importance of facilitating reorganizations, especially for SMEs, cannot be overstated. Start-up and small businesses create and provide a significant portion of jobs in the United States. . . . For example, in 2010, 505,473 new businesses were started. These businesses employed over 2,456,000 people.”), available at Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012), available at Commission website, *supra* note 55.

983 Donald R. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, 23 Cap. U. L. Rev. 413, 426–27 (1994) (“Larger businesses also tend to have more operational flexibility, and sometimes may weather economic slow-downs by shifting from one product line to another, or from one geographical area to another. In contrast, small businesses are less likely to have cash reserves, and they are generally undiversified in their products and customer base. Furthermore, small businesses are often in industries characterized by intense price competition. During inflationary times, they may not have the luxury of raising prices in order to compensate for rising operating expenses. Meanwhile, regulatory burdens and tax increases hit small business the hardest, depleting severely limited working capital.”) (citations omitted); *First Report of the Commercial Fin. Ass’n to the ABI Comm’n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass’n Annual Meeting*, at 2 (Nov. 15, 2012), available at Commission website, *supra* note 55 (“[A]lthough large U.S. corporations play an important role in the U.S. economy, CFA believes that an even greater role is played by small and medium-sized enterprises (“SMEs”). Commercial finance (in both its asset-based lending and cash-flow lending forms) has traditionally been, and continues to be, the backbone of financing for SMEs in the United States. Although many of the current suggestions for amending the Code (including some from Commissioners) are designed to address perceived problems arising in the chapter 11 cases of large corporations, these concerns are not necessarily applicable to chapter 11s of SMEs (which currently comprise the greatest number of chapter 11 cases).”).

984 See Bureau of Labor Statistics, *Business Development Dynamics, Entrepreneurship and the U.S. Economy*, available at http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

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ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11

Survival Rates of Establishments, by Year Started and Number of Years Since Starting, 1994–2010 (%)																	
No. of Years Since Starting	Year																
	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2	79.8	79.2	79.0	78.8	80.6	79.6	78.9	75.5	78.4	79.2	79.1	80.0	78.3	77.2	74.4	76.3	–
3	68.5	68.5	67.6	68.7	69.1	67.6	66.3	64.5	67.5	68.4	69.1	68.7	66.2	63.4	62.4	–	–
4	61.2	60.5	60.4	60.6	60.2	59.0	58.5	57.5	60.2	61.4	61.3	60.1	56.1	54.9	–	–	–
5	54.9	54.7	54.1	53.5	53.6	53.2	53.1	52.4	55.0	55.3	54.7	52.2	49.3	–	–	–	–
6	50.2	49.5	48.8	48.1	48.7	48.7	48.6	48.2	50.4	50.1	48.2	46.5	–	–	–	–	–
7	45.8	45.0	44.5	44.2	45.0	45.0	45.1	44.5	46.3	44.7	43.7	–	–	–	–	–	–
8	42.1	41.4	41.2	41.0	41.9	42.1	42.1	41.2	42.0	40.9	–	–	–	–	–	–	–
9	38.9	38.6	38.5	38.2	39.4	39.3	39.1	37.6	38.7	–	–	–	–	–	–	–	–
10	36.4	36.3	36.0	36.2	37.0	36.8	36.0	34.7	–	–	–	–	–	–	–	–	–
11	34.2	34.1	34.0	34.0	34.8	33.9	33.4	–	–	–	–	–	–	–	–	–	–
12	32.4	32.2	32.1	32.1	32.2	31.7	–	–	–	–	–	–	–	–	–	–	–
13	31.0	30.5	30.4	29.8	30.3	–	–	–	–	–	–	–	–	–	–	–	–
14	29.3	29.0	28.6	28.1	–	–	–	–	–	–	–	–	–	–	–	–	–
15	27.8	27.1	26.9	–	–	–	–	–	–	–	–	–	–	–	–	–	–
16	26.0	25.7	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–
17	24.6	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–	–

Note: Dashes indicate not applicable.

Source: Bureau of Labor Statistics, Business Development Dynamics, Entrepreneurship and the U.S. Economy, available at http://www.bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

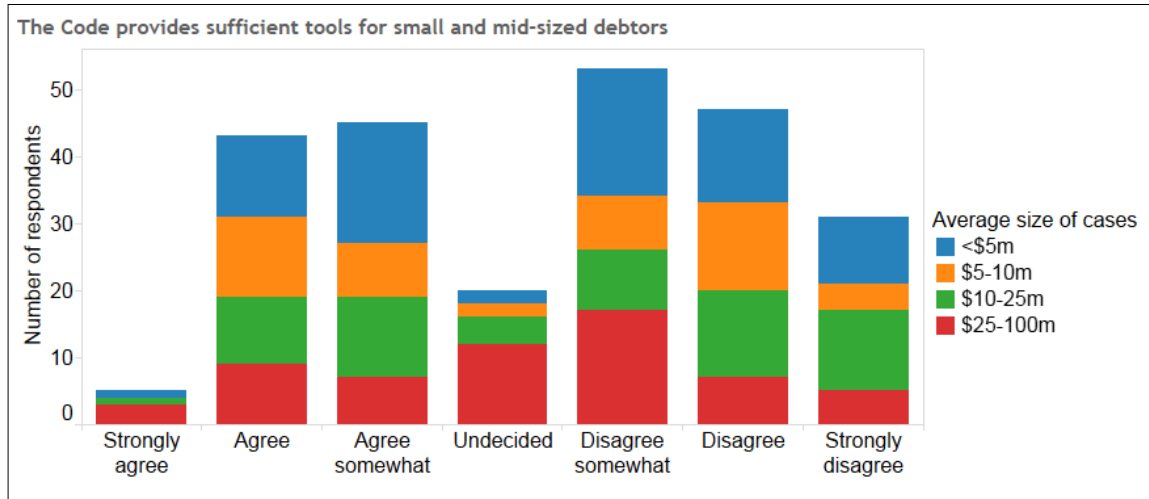
In addition, established small and middle-market companies can experience failed acquisitions, underperforming product lines, overcapitalization, and other factors that contribute to financial distress and threaten their survival. Yet many commentators and practitioners assert that the Bankruptcy Code no longer works to help rehabilitate these companies.⁹⁸⁵ As one witness testified, “Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender.”⁹⁸⁶

⁹⁸⁵ See, e.g., *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (“[C]omplexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome.”), available at Commission website, *supra* note 55. See also *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), available at Commission website, *supra* note 55; *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (“It is widely understood and agreed in the insolvency community that Chapter 11 is no longer a cost effective process in the middle market. . . . Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender.”), available at Commission website, *supra* note 55.

⁹⁸⁶ *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013), available at Commission website, *supra* note 55. See also *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), available at Commission website, *supra* note 55; *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), available at Commission website, *supra* note 55.

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The Commission heeded the concerns raised by several witnesses regarding the plight of small and middle-market enterprises in financial distress.⁹⁸⁷ These perspectives aligned with the results of an empirical survey conducted by Professor Dalié Jiménez, as illustrated in the following chart:⁹⁸⁸



The Commissioners solicited the testimony and input of practitioners and judges familiar with small and middle-market cases and thoroughly studied the issues identified as barriers to effective reorganizations in this space. They also, with the assistance of the Reporter and a report from the governance advisory committee, reviewed the literature and empirical evidence on small business cases in chapter 11. The Commission strongly believed that the following set of principles for small and middle-market enterprises can have a significant and positive influence on the ability of these companies to effectively reorganize in and outside of chapter 11.

⁹⁸⁷ For example, one witness noted that data from the Census Bureau and the Bureau of Labor Statistics indicate that entrepreneurship has decreased since 1994. The witness suggested that changes in the Bankruptcy Code were partially to blame. *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 & n. 1 (Nov. 3, 2012), available at Commission website, *supra* note 55. See also Michelle J. White, *Bankruptcy and Small Business*, Reg. Mag. 18, Summer 2001 (arguing that the BAPCPA reforms would make entrepreneurs less likely to start businesses), available at <http://object.cato.org/sites/cato.org/files/serials/files/regulation/2001/7/white.pdf>.

⁹⁸⁸ See Dalié Jiménez, *ABI Chapter 11 Survey Results*, Am. Bankr. Inst. J., July 2014, at 11 (containing the results of Professor Jiménez's entire survey). Professor Jiménez found that "[a]bout 15% of the then 2,158 members of the Business Restructuring Committee responded to the survey, for a total of 322 responses. While the response rate could have been higher, this is typical of online surveys and in line with previous ABI surveys. Nonetheless, these findings must be interpreted with a grain of caution." *Id.* See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

A. Definition of SME

Recommended Principles:

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

A debtor purporting to qualify as an SME under this definition must file a balance sheet reflecting a good faith estimate of its assets and liabilities as of the petition date with its chapter 11 petition.

- The court *sua sponte*, the U.S. Trustee, or a party in interest should be able to object to the debtor’s indication in the petition that it satisfies subsections (i) and (ii) above and qualifies as an SME, but only on the grounds that the debtor does not in fact meet the definition of SME under the Bankruptcy Code. Such objection should be filed on or before 14 days after notice of the debtor’s indication in the petition that it qualifies as an SME, and it should be heard on an expedited basis.
- In addition, if a business debtor satisfies subsection (i) above and has more than \$10 million but less than \$50 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates, the debtor may file a motion seeking to be treated as an SME in its chapter 11 case. Such motion must be filed with the debtor’s voluntary petition or within seven days after the entry of the order for relief in an involuntary case. The court should grant such motion and classify the debtor as an SME only if the motion is timely filed and the court determines based on evidence presented at the hearing that treating the debtor as an SME in the chapter 11 case is in the best interest of the estate. Any objection to such motion should be filed on or before 14 days after the filing of the motion, and the motion and any objections should be heard on an expedited basis.
- The definition of SME does not include a “single asset real estate” case as defined in section 101(51B) of the Bankruptcy Code.
- The “*small business case*” and “*small business debtor*” provisions of the Bankruptcy Code should be deleted in their entirety.

Definition of SME: Background

The utility of chapter 11 for smaller companies is not a new concern. Shortly after the enactment of the Bankruptcy Code, commentators raised concerns regarding the ability of smaller debtors to

confirm chapter 11 plans.⁹⁸⁹ Congress attempted to address these concerns in 1994 by introducing a small business election provision in chapter 11.⁹⁹⁰ The 1994 amendments defined “small business” as “a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed \$2,000,000.”⁹⁹¹ A person qualifying as a small business could elect themselves into a fast-track chapter 11 plan process that allowed the court, among other things, to conditionally approve the debtor’s disclosure statement and to combine the hearing on the adequacy of the disclosure statement and the approval of the plan.⁹⁹² The amendments also allowed the court to order that a committee of unsecured creditors not be appointed in a small business case.⁹⁹³

Congress further amended the small business provisions of chapter 11 in 2005 in response, at least in part, to the ongoing issues with small business cases identified by the National Bankruptcy Review Commission’s (the “**NBRC**”) study and report (the “**NRBC report**”).⁹⁹⁴ The NBRC report concluded that small business debtors fell into two categories: (i) a small number with a reasonable likelihood of reorganizing and succeeding as a going concern; and (ii) a larger number with no reasonable prospect of rehabilitation.⁹⁹⁵ The NBRC suggested that reform focus on increasing the likelihood of success for those debtors who might succeed and reducing the amount of time a likely-to-fail debtor spends in chapter 11.⁹⁹⁶

The NBRC report concentrated to some extent on those small business debtors that were unlikely to rehabilitate.⁹⁹⁷ The NRBC report indicated that small businesses benefited from the protections of chapter 11 — the automatic stay, retention of control of the business, ability to delay payments to creditors, and ability to delay formulating a chapter 11 plan — while administrative costs increased, even though there was no realistic prospect of rehabilitation.⁹⁹⁸ Chapter 11 arguably only prolonged these debtors’ imminent demise and reduced recoveries for creditors.⁹⁹⁹ The NBRC proposed reforms to address these likely-to-fail debtors and to try to reduce overall cost and delay for small business debtors.¹⁰⁰⁰ These changes included establishing presumptive plan filing and plan confirmation

989 See LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 749–51 (1993) (discussing how the initial identical treatment of large and small business cases evolved).

990 See *id.* at 751–52 (describing how the procedures developed by Judge Small resulted in the small business reorganization pilot program in 1992 and ultimately the legislative changes to the Bankruptcy Code in 1994); James B. Haines, Jr. & Phillip J. Hendel, *No Easy Answers: Small Business Bankruptcies After BAPCPA*, 47 B.C.L. Rev. 71, 73 (2005).

991 11 U.S.C. § 101(51C) (1994).

992 *Id.* §§ 1121, 1125 (1994).

993 *Id.* § 1102(a) (1994).

994 NBRC Report, *supra* note 37. See also Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 Am. Bankr. L.J. 645 (2005).

995 NBRC Report, *supra* note 37, at 609.

996 *Id.*

997 See H. Rep. No. 109-31, Part 1, at 3 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89 (noting that the legislation includes “several significant provisions intended to heighten administrative scrutiny and judicial oversight of small business cases, which often are the least likely to reorganize successfully”).

998 See Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381, 382–83 (2007) (citing others who believe that chapter 11 allows firms that should be liquidated to linger on indefinitely).

999 NBRC Report, *supra* note 37, at 612–13 (“The length of time a business remains in Chapter 11 is critically important. ‘During that time, the business is at risk because management incentives are inappropriate, professional fees build up at a rapid rate, and business uncertainties increase.’ Furthermore, unsecured creditors lose the time value of money while they wait to collect their debt during the pendency of the case. The longer they await distribution, the greater is their loss.”) (citing Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 Am. Bankr. L.J. 99, 100 (1983); Philip J. Hendel, *Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities* (Dec. 17, 1996)).

1000 See H. Rep. No. 109-31, Part 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105 (stating that the “variety of time frames and enforcement mechanisms [were] designed to weed out small business debtors who are not likely to reorganize”); NBRC Report,

deadlines,¹⁰⁰¹ additional postpetition documentation requirements, more reporting, and changes to the burden of proof for small business debtors.¹⁰⁰² In adopting these provisions, Congress also removed the elective nature of the small business provisions and amended the definition of the “small business debtor” that would be subject to these mandatory provisions.¹⁰⁰³

At that time, some commentators testified before the NBRC that the reduced deadlines would provide too little time and shifting the burden of proof would be too onerous, and that these provisions would deprive debtors of a fair opportunity to reorganize in chapter 11.¹⁰⁰⁴ Others commented that the system was working relatively well and that bankruptcy judges were doing a good job of filtering failing firms from viable ones.¹⁰⁰⁵ Unfortunately, time has proven those commentators right to some extent. Witnesses before the Commission generally testified that chapter 11 is not working for small and middle-market debtors, and several of these witnesses suggested that certain of the deadlines imposed by the BAPCPA amendments were particularly challenging and counterproductive for small business debtors.¹⁰⁰⁶

¹⁰⁰¹ *supra* note 37, at 609 (stating that for the large group of debtors with “no reasonable prospect for rehabilitation . . . the primary goal is to reduce the amount of time they consume in Chapter 11”).

¹⁰⁰² NBRC Report, *supra* note 37, at 615.

¹⁰⁰³ *Id.* at 618–25.

¹⁰⁰⁴ *Id.* at 618. See also Haines & Hendel, *supra* note 990. Section 101(51D) defines “small business debtor” as follows:

(A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than \$2,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,000,000 (excluding debt owed to 1 or more affiliates or insiders).

11 U.S.C. § 101(51D). Several commentators have criticized the definition as being too complex and difficult to apply in many cases. See, e.g., Anne Lawton, *An Argument for Simplifying the Codes “Small Business Debtor” Definition*, 21 Am. Bankr. Inst. L. Rev. 55 (2013). For example, the types of assets at issue may give rise to questions concerning whether the debtor is a small business case or a single asset real estate case. *Id.* at 72–76. Likewise, determining whether liabilities are noncontingent and liquidated may not be a straightforward calculation. *Id.* at 83–88.

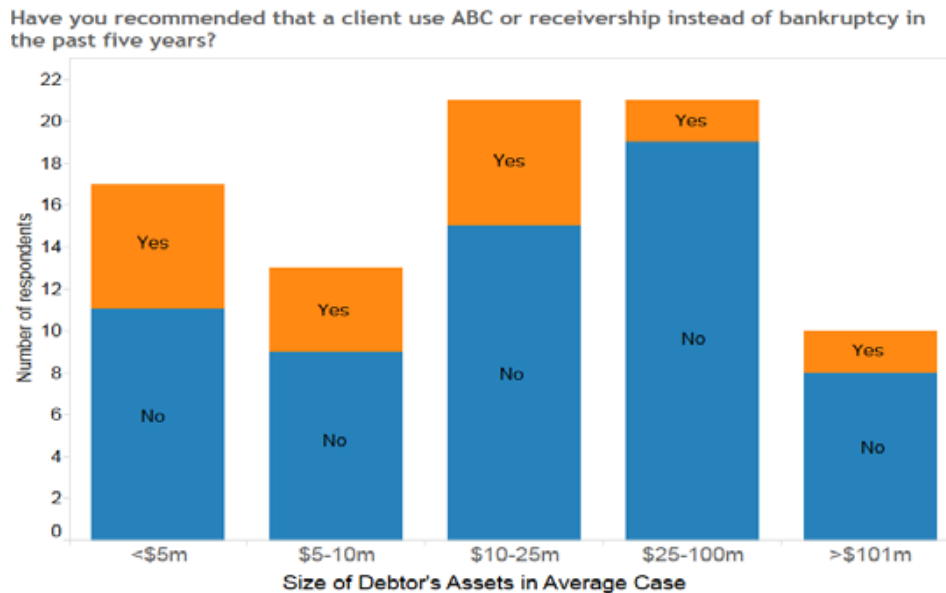
¹⁰⁰⁵ NBRC Report, *supra* note 37, at 616.

¹⁰⁰⁶ See Douglas G. Baird, *Remembering Pine Gate*, 38 J. Marshall L. Rev. 5, 15 & n. 35 (2004) (“The benchmark by which to judge the bankruptcy system in small cases is not the sheer number of businesses saved, but their ability to sort effectively and quickly. Most important is identifying those cases in which the debtor is only playing for time. The evidence suggests that bankruptcy judges can do this job exceedingly well. Indeed, the data are consistent with the conjecture that bankruptcy judges perform this job as well as a market actor subject to the same constraints.”) (citing Morrison, *Bankruptcy Decisionmaking*, *supra* note 998). Morrison conducted an empirical study of nearly all the chapter 11 cases filed by corporations outside the real estate sector who filed in the Northern District of Illinois in 1998. He found that the bankruptcy process identified over 70 percent of nonviable firms within six months and 44 percent were identified within three months; only 8.5 percent of nonviable firms had not been identified by one year. See Morrison, *Bankruptcy Decisionmaking*, *supra* note 998, at 14. See generally *supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). See also Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009) (finding that the pre-BAPCPA system was successfully screening cases).

¹⁰⁰⁷ Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 1–2 (Apr. 19, 2013) (stating it is nearly impossible to do anything but have a section 363 sale in the middle market), available at Commission website, *supra* note 55. “Middle-market companies just do not have either the management or financial resources to attempt to remain in Chapter 11 long enough to reorganize.” *Id.* See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 1–2 (Apr. 19, 2013), available at Commission website, *supra* note 55; Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11 (Nov. 15, 2012) (requesting that the BAPCPA plan deadlines be repealed because “the secured lender is concerned about these deadlines and consequently takes action (or requires the debtors to take action) months before these deadlines occur in order to reduce its credit risk — all of which hurts the flow of funds to the debtor and ultimately inures to the detriment of the reorganization process”), available at Commission website, *supra* note 55.

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Moreover, several witnesses and commentators have observed an increasing use of state and federal law insolvency alternatives by small and middle-market enterprises in lieu of a chapter 11 filing.¹⁰⁰⁷ These alternatives include state and federal receiverships and assignments for the benefit of creditors (“ABCs”) under state law.¹⁰⁰⁸ This testimony again generally aligned with the results of the empirical survey conducted by Professor Jiménez, as illustrated by the following chart:¹⁰⁰⁹



In a receivership, a person — the receiver — is appointed by a court to take property into custody and preserve it; receiverships are often used as a method for liquidating entire businesses.¹⁰¹⁰ Commentators argue that receiverships are attractive for several reasons: Receivers may be granted powers that are broader and more flexible than those under the Bankruptcy Code;¹⁰¹¹ nonbankruptcy courts are able to use summary remedies to allow, disallow, and subordinate the claims of creditors,

1007 Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3 (Apr. 19, 2013) (stating that the use of federal receiverships is growing in the insolvency community but noting that the federal statute on receiverships does not have well-developed processes and rules), available at Commission website, *supra* note 55; Written Statement of John Haggerty: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 1 (Apr. 19, 2013) (noting that there has been an increase in the use of out-of-court alternatives for turnarounds, restructurings, sales and liquidations, particularly for smaller businesses), available at Commission website, *supra* note 55.

1008 See *id.* See also Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255, 256 (2009) (stating that in 2003, about 540,000 small businesses closed their doors but only 34,000 filed for bankruptcy and that the “vast majority of small businesses resolve distress under state law”); Edward R. Morrison, *Bankruptcy's Rarity: Small Business Workouts in the United States*, 5 Euro. Co. & Fin. L. Rev. 172 (2008) (asserting that federal bankruptcy filings account for only three to four percent of all business closures). Accord Edward I. Altman et al., *The Value of Non-Financial Information in SME Risk Management*, J. Credit Risk, Summer 2010, at 7 (distinguishing between failure and closure and citing a study that indicated about 33 percent of new businesses closed because they were unsuccessful) (citation omitted), available at http://people.stern.nyu.edu/ealtman/Altman-Sabbato-Wilson-JCR_2010.

1009 See Jiménez, *supra* note 988, at 79. Professor Jiménez found that “[m]ore than a quarter (26 percent) had been involved in an equity receivership in the past five years. Most of these (69 percent) noted that their participation in federal equity receivership cases had increased in the last five years, 27 percent thought it was about the same, and only 5 percent responded that it had decreased.” *Id.*

1010 Business Organizations with Tax Planning § 155.01.

1011 M. Colette Gibbons et al., *Lien on Me*, Ohio Lawyer, May/June 2011, at 18; M. Colette Gibbons & Jason Grimes, *A Model Statute for Free-and-Clear Sales by Equity Receivers*, Am. Bankr. Inst. J., Mar. 2009, at 3. See also 16 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedures § 3925 (3d ed.) (“A receivership can drastically curtail existing property rights. . . .”); SEC v. Black, 163 F.3d 188 (3d Cir. 1998) (“[W]here there is a receiver with equitable power in a proceeding before it, the District Court has wide discretion as to how to proceed.”); SEC v. Hardy, 803 F.2d 1034 (9th Cir. 1986) (“[A] district court’s power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad.”); SEC v. Safety Fin. Serv., Inc., 674 F.2d 368 (5th Cir. 1982) (“It is a recognized principle of law that the district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership.”).

which promotes judicial efficiency and reduces litigation costs;¹⁰¹² lack of certainty in chapter 11 due to divergent case law;¹⁰¹³ and lastly, receiverships are less time-consuming and costly than chapter 11 to liquidate property.¹⁰¹⁴ Receivership has traditionally been considered an extraordinary remedy¹⁰¹⁵ and may only be available in specific circumstances,¹⁰¹⁶ particularly when statutory authority for the receivership is lacking.¹⁰¹⁷

An ABC involves a consensual transfer of assets by the debtor to an assignee who holds them in trust for the benefit of creditors.¹⁰¹⁸ ABCs are a function of state law, with many states requiring court supervision of the ABC and with other states not requiring such oversight.¹⁰¹⁹ The law governing ABCs, like the law covering receiverships, is often a mixture of common law and statutory law and varies significantly by state.¹⁰²⁰

These state law alternatives are subpar remedies in many circumstances and present their own problems. For example, some debate a receiver's ability to sell property free and clear of liens without the consent of all lienholders.¹⁰²¹ Case law is inconsistent as well.¹⁰²² In an ABC, any nonconsenting creditors are not bound by any conditions contained in the assignment and the ABC does not displace even the consenting creditors' original claims, unless there is a release.¹⁰²³ And even though these nonbankruptcy procedures are generally faster and cheaper, they are also more private and generally less transparent.¹⁰²⁴ This may hide insider self-dealing or preferential treatment of certain creditors.¹⁰²⁵ Nevertheless, the prevailing perception that chapter 11 no longer works for small and middle-market enterprises has forced many companies to consider these alternatives.

1012Gibbons & Grimes, *supra* note 1011, at 3 (citing SEC v. Basic Energy & Affiliated Res. Inc., 273 F.3d 657, 668 (6th Cir. 2001)). See also SEC v. Elliott, 953 F.2d 1560 (11th Cir. 1992), *rev'd in part on other grounds sub nom.* SEC v. Elliott, 998 F.2d 922 (11th Cir. 1993) (*per curiam*).

1013Gibbons & Grimes, *supra* note 1011, at 3 (discussing the decision in *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), in which the court held that the sale of the debtor's assets was not free and clear of all liens when the price paid did not exceed the aggregate value of all liens on the property, in violation of section 363(f)(3)).

1014See Business Organizations with Tax Planning § 155.01 ("Cost is often the major factor that makes a receivership attractive when compared to a federal bankruptcy proceeding").

1015Id. (citing *Solis v. Matheson*, 563 F.3d 425, 437 (9th Cir. 2009), in which the court held that a receivership is an "extraordinary remedy" requiring "clear necessity" and should be "employed with the utmost caution"); *Peterson v. Islamic Republic of Iran*, 563 F. Supp. 2d 268, 277 (D.C. 2008) ("[A]ppointment of a receiver is an equitable remedy of rather drastic measure.").

1016Id. (citing *Case v. Murdock*, 528 N.W.2d 386, 388 (S.D. 1995); *Kuenning v. Broad & High Corp.*, 28 Ohio Misc. 211 (1971); *Hoiles v. Watkins*, 157 N.E. 557 (Ohio 1927)).

1017Id. (stating that when a receiver is appointed according to equitable principles — rather than being authorized by statute — a higher showing of imminent danger to the property may be necessary).

1018See *id.* (noting that "an assignment for the benefit of creditors is based on trust law, sometimes supplemented or modified by a specific state statute"). See also Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 Wash. U.L.Q. 1375 (2004) (discussing use of the ABC as an alternative to bankruptcy).

1019See generally Geoffrey L. Berman, *General Assignments for the Benefit of Creditors* (second edition) (2006).

1020Id. See also Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 4 ("An ABC, for example, is regulated by statute and overseen by courts in New York; it is unregulated and requires no court involvement in Illinois.").

1021Compare Gibbons & Grimes, *supra* note 1011, at 2 (asserting that receivers are able to sell property free and clear without the consent of all lienholders, with some caveats, and acknowledging there is case law to the contrary), with Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, at 786–87 (arguing that the liabilities sometimes follow the assets in such asset sales, even when that is not what the parties intended). See also *Mellen v. Moline Malleable Iron Works*, 131 U.S. 352, 367 (1889); *Broadway Trust Co. v. Dill*, 17 F.2d 486 (3d Cir. 1927); Gibbons, *Lien on Me*, *supra* note 1011, at 19–20.

1022See *Director of Transp. of Ohio v. Eastlake Land Dev. Co.*, 894 N.E.2d 1255, 1261 (Ohio Ct. App. 2008) (holding that the court did not have the ability to authorize receiver to sell debtor's property free and clear of all liens over the creditor's objection) ("[W]e believe the courts do not have the power in receiver proceedings to take away lien rights in property which were vested by contract or by operation of law without the consent of lien holders.") (citations omitted); *Quill v. Troutman Enters, Inc.*, 2005 WL 994676 (Ohio Ct. App. Apr. 29, 2005) (allowing receiver to sell property free and clear of liens over creditor's objection). See also Gibbons & Grimes, *supra* note 1011, at 2; M. Colette Gibbons & Melanie Shwab, *Park National Bank Affirms the Ability of Receivers to Sell Real Property Free and Clear of Liens*, *Cleveland Metropolitan Bar J.*, Dec. 2010, at 14–16.

1023Business Organizations with Tax Planning § 156.01.

1024Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 8–9 (noting that it may be difficult for creditors to audit the distressed business outside of bankruptcy).

1025Id.

Definition of SME: Recommendations and Findings

The Commission reviewed the history of the small business debtor provisions and the various proposals to address small business chapter 11 issues that have been proposed in the past, including the NBRC report discussed above and proposals by the Honorable A. Thomas Small of the U.S. Bankruptcy Court for the Eastern District of North Carolina¹⁰²⁶ and the American Bar Association's Select Advisory Committee on Business Reorganizations.¹⁰²⁷ It also considered empirical data, including thoughtful studies by Professor Anne Lawton and Professor Edward Morrison,¹⁰²⁸ and the industry and academic literature analyzing the financial distress of, and restructuring options for, small and middle-market enterprises. Finally, the Commission was aided in its deliberations by witness testimony.

The first question raised by the Commissioners concerned the need for, and the value of, separate chapter 11 provisions for different types of debtors. The Commissioners discussed the very large — or “mega” — chapter 11 cases that often dominated the media headlines. These cases certainly would benefit from the general reform principles proposed by the Commission, but the Commission did not believe that targeted chapter 11 provisions would further assist these debtors. The Commissioners also observed the relatively small number of mega cases filed on an annual basis and that many jurisdictions had adopted special local rules to address certain administrative and procedural issues that commonly arise in those cases.¹⁰²⁹

The Commissioners did not generally believe, however, that a “one-size-fits-all” approach to chapter 11 is the best approach. In addition to the mega cases, the Commissioners found that the general reform principles being proposed identified and responded to key issues for the more established, upper-middle-market and larger company cases. These cases often struggled with liquidity early in the process, timing issues surrounding their exit strategy and value allocation, and case-specific investigations, litigation, or negotiations. These debtors also typically benefit from the advice and counsel of restructuring professionals and have more experienced management teams.¹⁰³⁰

On the other hand, the Commissioners identified significant and troubling issues for small and lower-to-middle-market enterprises. (These principles refer to these companies as “small and medium-sized enterprises (SMEs).”) In working to develop the parameters of companies in this

¹⁰²⁶See, e.g., A. Thomas Small, *Suggestions for the National Bankruptcy Review Commission: Small Business Reorganization Chapter*, 4 Am. Bankr. Inst. L. Rev. 550, 550 (1996).

¹⁰²⁷See Karen M. Gebbia-Pinett, *Small Business Reorganizations and the SABRE Proposals*, 2 Fordham J. Corp. & Fin. L. 253 (2002).

¹⁰²⁸Anne Lawton, *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success*, 54 Ariz. L. Rev. 985, 995–1001 (2012); Morrison, *Bankruptcy Decisionmaking*, *supra* note 998; Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008; Morrison, *Bankruptcy's Rarity*, *supra* note 1008, at 3 (asserting that federal bankruptcy filings account for only three to four percent of all business closures).

¹⁰²⁹See, e.g., Laura B. Bartell, *A Guide to the Judicial Management of Bankruptcy Mega-Cases* (2d ed. 2009), available at [http://www.fjc.gov/public/pdf.nsf/lookup/BkMega21.pdf/\\$file/BkMega21.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/BkMega21.pdf/$file/BkMega21.pdf).

¹⁰³⁰*First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 15–16 (Nov. 15, 2012) (“The “mega” cases and the “pre-arranged” or “pre-pack” cases come to the Bankruptcy Court with many issues having already been pre-negotiated among the various constituencies in the debtor's capital structure. There is often consensus among the debtor and the various creditor groups and their representatives as to financing and management and, indeed, many times even agreement on an exit strategy. These creditor groups are in almost all cases represented by counsel. These cases differ markedly from the typical SME filing where the debtor has had little, if any, contact with any creditors other than its secured lender. Given these differences, and many more not touched upon herein, it seems that in “mega” cases, the consent of the parties should override the normal findings and statutory pre-requisites for such issues as DIP financing and other “first day” decisions, such as the payment of pre-petition obligations (including the payment of “critical vendors”). However, in the non-mega or non-pre-arranged cases, it is necessary to maintain the statutory construction set forth in the Code, tempered by the Court's judicial discretion and the exercise of business judgment.”), available at Commission website, *supra* note 55.

space, the Commissioners discussed companies that have less experienced management teams,¹⁰³¹ relatively smaller pools of assets and liabilities, relatively smaller revenue streams,¹⁰³² challenges with understanding the nature of their financial issues or the potential tools available to help them address those issues,¹⁰³³ and vested equity owners who likely either founded the company or help manage the company.¹⁰³⁴ The Commissioners also stressed the importance of these companies possessing viable business models, recognizing that chapter 11 should not be used to delay the inevitable failure of a company. The Commissioners firmly believed, however, that many of these SMEs were failing not because of fatally flawed business models, but because they were not receiving the assistance they needed in the context of a financial restructuring. This belief has been supported by witness testimony and some of the related literature.¹⁰³⁵

1031 Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 427–28 (“Small business managers may be unable to afford adequate managerial training for themselves or their employees, or regularly to hire accountants, bookkeepers, and other professional persons to assist their monitoring efforts. As a result of these factors, they may not discover that their business is in serious financial distress until the situation has deteriorated beyond the point of repair.”).

1032 Small businesses often have higher debt-to-equity ratios than larger firms, and financing tends to come in the form of short-term bank financing for which they generally pay higher interest rates. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 (“As a result of these real limits on obtaining capital, small businesses often confront cash flow problems. Without available funds, they may be unable to exploit market opportunities in their purchase of raw materials and inventory, or to pursue attractive investment opportunities. Cash flow constraints may amplify the ramifications of simple management errors and, in less prosperous times, make small businesses more susceptible to default.”); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. Small & Emerging Bus. L. 181, 194–95 (2000) (“Inadequacy of financial resources, combined with little leverage and market power, can lead to a host of other difficulties such as shortage of operating funds, lack of cash flow, and lack of access to long-term credit. The difficulty in obtaining long-term financing, which leads to heavy reliance on short-term credit (often in the form of credit cards or personal borrowing by the proprietor), is regarded by many writers as one of the most significant reasons for small business failure. Short-term financing allows the business to continue operations without profit for a period of time, but leaves it illiquid and unable to absorb fluctuations in cash flow.”).

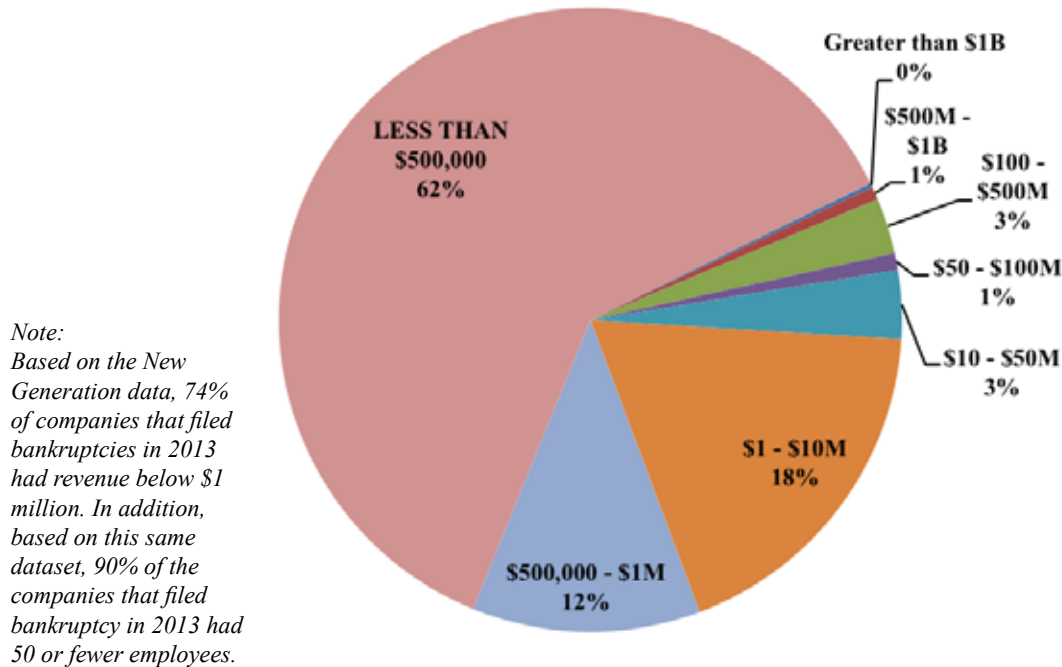
1033 *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) (“[Small business debtors] often lack the resources to recruit new management or hire experienced insolvency professionals. Their reorganization is also made more difficult by challenges that are common to smaller businesses, such as lack of proprietary products, customer concentration, vendor concentration, difficulty in raising capital, and relative insignificance to many of their lenders and creditors. While it might take the experienced turnaround professional only weeks to determine if the company is a candidate for turnaround and restructuring, the aforementioned circumstances make rehabilitation more challenging and time consuming.”), available at Commission website, *supra* note 55; Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 (noting that small businesses are less likely to have cash reserves and do not have a diverse product line or diverse customer base; also stating that “small business managers may be less likely to detect the symptoms of financial distress at the very earliest stages” because of their short-term perspective); Blum, *supra* note 1032, at 195.

1034 See, e.g., Haines & Hendel, *supra* note 990, at 85 (noting that small business managers are often the owners and discussing how bankruptcy can be a significant distraction); LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 758 (noting that the market for small companies is virtually nonexistent because “[w]ithout their owner-managers, most have no value at all”); LoPucki, *The Debtor in Full Control*, *supra* note 999, at 264 (noting that owner-managers exist in a significant majority of all reorganizing companies); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Surv. Am. L. 9, 39–42 (1991) (noting that owner-managers of small businesses may be able, despite the absolute priority rule, to retain control of the emerging company by purchasing the equity for new value); Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 425 (stating that because of the absolute priority rule, the owner-managers common in small businesses may be reluctant to file a petition before the company is in dire condition because in bankruptcy, they risk losing their financial interests in the business).

1035 See, e.g., Robert N. Lussier, *Reasons Why Small Businesses Fail*, 1 Entrepreneurial Exec. 10, 11–14 (1996) (noting that there is no agreement on the factors that cause small businesses to succeed or fail but noting that lack of adequate financing is among the most commonly cited factors for failure); Teresa A. Sullivan et al., *Financial Difficulties of Small Businesses and Reasons for Their Failure 23–24* (1998), available at <http://archive.sba.gov/advo/research/rs188tot.pdf>; Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499, 556–59 (1999) (finding that in a survey of small business debtors, the most cited reason (38.5 percent) for bankruptcy was financing issues such as high debt service, loss of financing, or inability to get financing); *Written Statement of the Honorable Melanie L. Cyganowski (Ret.)*, former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 3 (Nov. 15, 2012) (“Without the historical secured lender coming forward on Day 1, the middle-market Chapter 11 case usually cannot survive until the final hearing. Consequently, those Code provisions, . . . which require the debtor to seek other financing and competitive rates, are in most cases irrelevant because the debtor — in almost all of the cases over which I presided — had difficulty maintaining its existing credit relationships upon the filing of a bankruptcy petition, much less discovering alternative relationships.”), available at Commission website, *supra* note 55; *Written Statement of Holly Felder Ettlin: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 3–4 (Apr. 19, 2013) (“While the pre and post BAPCPA provisions are necessary for financial markets to function, they did not properly take into account their use as financing vehicles. When the principal lender to a business has the absolute ability to liquidate the assets subject to their agreement, the company is DOA on the steps of the bankruptcy court.”), available at Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) (“[T]he challenges to finance smaller businesses have been well documented, even for those that are making a profit. The challenge is far greater for those companies

To assess the types of companies within the SME category, the Commission reviewed historical data regarding the types of companies filing for bankruptcy. The Commissioners analyzed data prepared from a database of all business bankruptcy filings (both chapter 7 and chapter 11) maintained by New Generation Research. These data included annual revenue for all but 670 of the 11,261 businesses that filed for chapter 7 or chapter 11 bankruptcy in 2013. These revenue data break down as follows:¹⁰³⁶

Revenue of Debtors Filing for Bankruptcy in 2013



The Commissioners found the revenue and employee information very informative, but they acknowledged that these data points were not readily available on the petition date for any particular debtor. Accordingly, using these measures to define SMEs would be administratively difficult and, although feasible prospectively, such measures would not have the benefit of precedent in terms of interpretation and scope.

The Commissioners then reviewed data points more readily available for chapter 11 debtors: assets and liabilities. All debtors list these data points in a general manner in the bankruptcy petition and in a more specific manner in the schedules of assets and liabilities. Although also subject to

facing financial stress and for those seeking a DIP loan. Shareholders of smaller companies are also reluctant to lend money, even well documented and at reasonable interest rates, for fear that their loan might be treated as additional equity. Some file without a DIP loan in place, compelling management to spend [an] inordinate amount of time to obtain capital or face liquidation.”), available at Commission website, *supra* note 55; *Written Statement of Robert Katz: CFA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) (“While seemingly there is more money and more potential lenders/investors today than ever, it doesn’t necessarily trickle down to the middle market. Some middle- and low-middle-market companies going through a Chapter 11 process are still having trouble attracting capital. . . .”), available at Commission website, *supra* note 55.

¹⁰³⁶Mr. Shrestha prepared this chart for the Commission based on data from the New Generation’s Business Bankruptcy Filing Database. Accordingly, it was limited to public and large private companies.

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definitional and interpretational issues, courts and practitioners have dealt with these concepts since the inception of the Bankruptcy Code and are more familiar with their application. The Commission asked Professor Anne Lawton to prepare several analyses of chapter 11 debtors' assets and liabilities based on the datasets she built for chapter 11 filings in 2004 and 2007.¹⁰³⁷ The data in Professor Lawton's dataset are taken from a random sample drawn from the population of chapter 11 cases filed in calendar year 2007.¹⁰³⁸ The population includes all chapter 11 cases filed in each of the 94 judicial districts in the United States. *Individual and business filers* alike are included, as are both voluntary and involuntary cases. The asset and liability data are summarized in the following charts:

DEBTORS' ASSETS BASED ON SCHEDULES			
Asset Ranges	Number of Cases	Percent of Total Number of Cases	Cumulative Percent of Cases
\$0 – \$100,000	111	17.4%	17.4%
\$100,001 – \$500,000	119	18.6%	36.0%
\$500,001 – \$1 million	91	14.2%	50.2%
\$1,000,001 – \$2.19 million	117	18.3%	68.5%
\$2,190,001 – \$5 million	99	15.5%	84.0%
\$5,000,001 – \$10 million	47	7.4%	91.4%
\$10,000,001 – \$50 million	44	6.9%	98.3%
\$50,000,001 – \$100 million	4	0.6%	98.9%
Over \$100 million	7	1.1%	100%
Total	639	100%	

DEBTORS' LIABILITIES BASED ON SCHEDULES			
Liability Ranges	Number of Cases	Percent of Total Number of Cases	Cumulative Percent of Cases
\$0 – \$100,000	34	5.3%	5.3%
\$100,001 – \$500,000	111	17.3%	22.6%
\$500,001 – \$1 million	80	12.5%	35.1%
\$1,000,001 – \$2.19 million	149	23.2%	58.3%
\$2,190,001 – \$5 million	126	19.7%	78.0%
\$5,000,001 – \$10 million	56	8.7%	86.7%
\$10,000,001 – \$50 million	66	10.3%	97.0%
\$50,000,001 – \$100 million	8	1.2%	98.3%
Over \$100 million	11	1.7%	100%
Total	641	100%	

The Commissioners carefully analyzed Professor Lawton's data and discussed its implications. They observed a natural breaking point in the data at the \$10 million threshold.¹⁰³⁹ They examined the types of companies that might be captured by a definition that included companies with \$10 million or less in assets or liabilities. They considered this question based on industry and geographic region, methodically walking through the different companies that could be captured by such a definition. Through this analysis, the Commissioners agreed that public companies (*i.e.*, those with publicly issued debt or equity securities) should be excluded from any SME designation in all instances. Moreover, at the end of these deliberations, the Commissioners determined that the \$10 million or

¹⁰³⁷Professor Lawton used the same process to create both the 2007 and 2004 datasets. For a more detailed explanation of this process, see Lawton, *Chapter 11 Triage*, *supra* note 1028, at 995–1001.

¹⁰³⁸The initial sample consisted of 690 cases. The number of chapter 11 cases filed in 2007 was much smaller than that in 2004 and, hence, the population of cases from which the random sample was drawn was smaller. The initial random sample, however, was approximately the same in 2004 and 2007 — in the range of 10.5 percent to 10.8 percent of the respective year's population.

¹⁰³⁹Professor Lawton's 2004 dataset suggests that for *all* chapter 11 filings, 91.6 percent of the debtors had assets (based on schedules) of \$10 million or less, and 88.2 percent had liabilities (based on schedules) of \$10 million or less. See *generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

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less in assets or liabilities standard corresponded with the characteristics identified above of SMEs that are not being well served by current law.

The Commissioners recognized that this standard would capture around 85 percent to 90 percent of the chapter 11 filings, at least based on Professor Lawton's datasets and adjustments to exclude *individual* chapter 11 filings (the overwhelming majority of which fall under the \$10 million threshold) and any small *public* companies.¹⁰⁴⁰ As previously noted, the Commission did not consider reform proposals for individual chapter 11 debtors, and it did not intend individuals to be covered by the recommended principles for SME debtors.

The Commissioners also discussed whether to include any of the factors or qualifications in the current definition of small business debtor. The Commission rejected making the definition overcomplicated and, as such, declined to require liabilities to be "noncontingent" or "liquidated," for example.¹⁰⁴¹ It also agreed that a debtor should be able to qualify as an SME based on either assets or liabilities. Nevertheless, the Commission determined that the asset and liability calculations should be performed on a consolidated basis with any affiliates to ensure that smaller businesses within a larger, more complex corporate family were excluded. It further concluded that single asset real estate cases should be excluded from the definition of SME, but that such determinations should be based solely on the single asset real estate definition in section 101(51B) of the Bankruptcy Code.¹⁰⁴²

Several Commissioners raised two related points: (i) nonpublic companies that do not qualify under this standard based solely on an asset or liability basis may have a very simple business and capital structure that could benefit from the tools and process proposed for small and middle-market enterprises, but (ii) a standard that allowed larger nonpublic companies to qualify for the process also could capture companies with very complex business and capital structures that need to filter through the general chapter 11 process. The Commissioners acknowledged the validity of both scenarios and examined alternatives to appropriately address each. The Commission agreed that nonpublic companies with assets or liabilities in excess of \$10 million but less than \$50 million should be able to request to be treated as an SME, but that the U.S. Trustee and parties in interest should have the ability to challenge the designation. The Commission also agreed that the court should only grant the request if it is in the best interests of the estate.

The Commissioners used this definition of SMEs and the underlying objectives to develop a comprehensive set of principles to guide and facilitate more effective chapter 11 cases for SMEs. Accordingly, the Commission voted to recommend the adoption of the SME principles and the deletion of the small business debtor and small business case provisions from the Bankruptcy Code.

¹⁰⁴⁰For example, in the 2007 dataset, Professor Lawton was able to identify 171 individual chapter 11 filings with liabilities of \$10 million or less. Removing these individual filers (and the four individual filers with more than \$10 million in liabilities) from the dataset reduced the percentage of business chapter 11 filings with \$10 million or less in liabilities (based on schedules) to 83 percent. Similarly, in the 2004 dataset, the percentage of business chapter 11 filings with \$10 million or less in liabilities (based on schedules) drops to 86 percent. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

¹⁰⁴¹*See* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 992–93 (explaining complex calculation issues under current definition of "small business debtor").

¹⁰⁴²The Commissioners did not recommend maintaining the current qualifier in the definition of "small business debtor" in section 101(51D) that the debtor be involved in "commercial or business activities (including any affiliate of such person that is also a debtor under this title and *excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto*)." 11 U.S.C. § 101(51D) (emphasis added). *See also* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1026 n. 149 (explaining challenges in applying real estate exclusion in definition of "small business debtor").

B. General Application of SME Principles

Recommended Principles:

- A debtor that satisfies the definition of an SME should be subject to the principles set forth herein for SME cases without further action by the court, trustee, or debtor in possession.
- If an objection is timely filed to the debtor's indication in the petition that it qualifies as an SME under the Bankruptcy Code definition, such debtor should be treated as an SME unless and until the entry of an order of the court sustaining any such objection.
- If a debtor timely files a motion seeking to be treated as an SME, such debtor should be treated as an SME only upon the entry of an order of the court overruling any objections thereto and authorizing the debtor's designation as an SME.
- If a debtor qualifies or is designated as an SME, the court may for cause, after notice and a hearing, permit the SME debtor to use good faith estimates in compiling its valuation information package, as required by the principles, if audited or unaudited financial statements are not readily available. The court also may set a deadline by which the SME debtor should turn over its valuation information package, to a requesting party in interest. *See* Section IV.A.6, *Valuation Information Packages*.
- The general recommended principles proposed for chapter 11 cases apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

General Application of SME Principles: Background

As noted above, Congress introduced the small business provisions into the Bankruptcy Code as an elective process. Debtors who satisfied the original definition of "small business" could elect to proceed with the fast-track plan confirmation procedures. Congress removed the elective nature of the small business provisions in 2005 pursuant to the BAPCPA Amendments. The current provisions mandate small business treatment if, among other things, the debtor has less than \$2,190,000 in total secured and unsecured debts and there is no active unsecured creditors' committee in the case.

Although the current small business provisions are mandatory and self-executing, several commentators have suggested that small business debtors are not self-reporting and may not be proceeding as small business cases. For example, Professor Robert Lawless observed that "there were 2,299 chapter 11s filed in 2007 where (i) the debtor was not an individual, (ii) [the debtor] said they had predominately business debts, and (iii) the total liabilities were between \$50,000 and \$1,000,000. Because very few small chapter 11 cases have unsecured creditors' committees, almost every one of

these 2,299 cases should have identified as small business debtor, but only 36.8 percent did so.”¹⁰⁴³ Now, the failure to self-identify as a small business debtor may be an oversight, it may be the result of the somewhat complicated definition of “small business debtor” described above, or it may be a desire to avoid the obligations and deadlines imposed on small business debtors under current law. Regardless of the reason, however, the consequences can be significant, including a determination that the small business debtor deadlines apply from the petition date, even if the non-designation is not corrected or is not deemed incorrect by the court until much later in the case.¹⁰⁴⁴

General Application of SME Principles: Recommendations and Findings

The three primary objectives underlying the Commission’s approach to the SME principles were (i) simplifying the process; (ii) reducing costs and barriers; and (iii) providing tools to facilitate effective reorganizations for viable companies. With these objectives in mind, the Commission determined that a hybrid approach to the application of the SME principles would work best. Accordingly, if the debtor is a nonpublic company that satisfies the asset or liability standard, it automatically invokes the SME principles. If the debtor is a nonpublic company that does not qualify, but it has assets or liabilities less than \$50 million and believes that the SME principles would better serve its estate and stakeholders, it can make a request to be treated as an SME debtor.

The Commissioners were mindful that some companies might try to manipulate the standard or self-identify as an SME when the standard is not satisfied, but they believed that those concerns are appropriately addressed by allowing the U.S. Trustee and parties in interest to object to the designation in the petition or a debtor’s request to be treated as an SME. In both instances, however, the Commissioners understood the importance of these matters being resolved quickly to allow the debtor either the full benefit of the SME principles or appropriate time to consider proceeding under the general chapter 11 principles. They believed that any delay in these determinations could significantly prejudice both the debtor and its stakeholders. The Commission also considered whether debtors would fail to self-report, as some commentators have suggested might be the case under the current law. Again, the Commissioners recognized that this was a possibility, but it believed that the SME principles incorporated appropriate incentives for the debtor and its estate so as to mitigate that risk.

¹⁰⁴³Bob Lawless, *The Disappearing Small Businesses (Designation) in Bankruptcy*, Credit Slips, (Apr. 30, 2010, 10:26 AM), available at <http://www.creditslips.org/creditslips/2010/04/the-disappearing-small-businesses-designation-in-bankruptcy.html>.

¹⁰⁴⁴See, e.g., *In re Display Grp., Inc.*, 2010 WL 4777550 (Bankr. E.D.N.Y. Nov. 16, 2010). Notably, the U.S. Trustee reviews a debtor’s chapter 11 petition and generally has 30 days following the section 341 meeting of creditors to object to the debtor’s designation or non-designation as a small business case. See Fed. R. Bankr. P. 1020(b) (2011).

C. Oversight of SME Cases

Recommended Principles:

- The debtor should be permitted to operate as a debtor in possession with all rights, powers, and duties set forth in section 1107 of the Bankruptcy Code and subject to the appointment of a chapter 11 trustee for cause under section 1104.
- A committee of unsecured creditors under section 1102(a) should not be appointed in an SME case unless an unsecured creditor or the U.S. Trustee files a motion with the court requesting the appointment of a committee and the court, after notice and a hearing, determines that the appointment is necessary to protect the interests of unsecured creditors in the case.
- If the debtor does not satisfy the Bankruptcy Code definition of SME but files a timely motion to be treated as an SME in the chapter 11 case, the U.S. Trustee should not appoint a committee of unsecured creditors unless the court denies the debtor's motion. The U.S. Trustee should suspend its ordinary appointment process pending resolution of the debtor's motion.
- If the debtor qualifies as an SME or is designated an SME by the court, the notice of the chapter 11 case served upon creditors should explain that the U.S. Trustee will not appoint a committee of unsecured creditors in the case unless such committee is requested by an unsecured creditor or the U.S. Trustee and the court orders such appointment. If the debtor indicates in its petition that it qualifies as an SME, such notice also should explain that parties in interest have 14 days from the date of such notice to object to the debtor's treatment as an SME.
- The court *sua sponte*, the U.S. Trustee, the debtor in possession, or a party in interest should be able to request the appointment of an estate neutral that also has the authority to advise the debtor in possession on operational and financial matters, as well as the content and negotiation of its plan. The standard for approval of an estate neutral and the U.S. Trustee's authority to appoint the estate neutral, if ordered by the court, should be governed by the general principles on estate neutrals. See Section IV.A.3, *The Estate Neutral*.
- Any estate neutral should represent the interests of the estate and be paid by the estate. The Bankruptcy Code could establish a fee structure available for the estate neutral in an SME case to control costs and increase certainty. Such structure could be based on the size of the case or the amount of creditor distributions.

Oversight of SME Cases: Background

As discussed above, the debtor in possession model used in chapter 11 cases makes oversight of the case particularly important.¹⁰⁴⁵ In most cases, the Bankruptcy Code establishes the U.S. Trustee and the committee of unsecured creditors as the statutory watchdogs in the case. Both of these parties have the ability to oversee and investigate certain aspects of the case and to appear and be heard with respect to matters pending in the case.¹⁰⁴⁶ (In addition, other creditors and equity security holders have standing to appear and be heard in the case under section 1109 of the Bankruptcy Code.) Nevertheless, in many SME cases, the U.S. Trustee may not be able to appoint a committee of unsecured creditors typically because of a lack of creditor interest in serving on the committee.¹⁰⁴⁷

The lack of creditor engagement was one reason cited by Congress in using the absence of a committee as a defining feature of a small business case. The legislative history of the BAPCPA Amendments explains:

Most chapter 11 cases are filed by small business debtors. Although the Bankruptcy Code envisions that creditors should play a major role in the oversight of chapter 11 cases, this often does not occur with respect to small business debtors. The main reason is that creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases.¹⁰⁴⁸

If an unsecured creditors' committee is not appointed in the small business debtor case, the debtor may drift in its case, achieving little, or it may cede to the desires of its secured creditors, even if those objectives do not align with the best interests of the estate.¹⁰⁴⁹ Accordingly, although the absence of a committee or creditor engagement may correspond to the size of the debtor or the complexity of the case, it does not mean that the debtor does not need oversight or assistance in the case.¹⁰⁵⁰

Oversight of SME Cases: Recommendations and Findings

The Commission viewed the administrative and oversight functions in an SME case as critical to the utility and effectiveness of the SME principles. The Commissioners wanted to develop principles that encouraged SMEs to file chapter 11 cases when appropriate, which meant reducing costs, simplifying disclosures and the process, and providing a way for the prepetition managers to stay in control of the business with some

¹⁰⁴⁵In the debtor in possession model, the business's prepetition board of directors, officers, and managers continue to manage the company's affairs and make decisions regarding the business and the reorganization. Some critics of the debtor in possession model argue that these prepetition actors contributed to the business's failure and also express concern that the prepetition management may not be aligned with the best interests of the estate. See Section IV.A.1, *The Debtor in Possession Model*.

¹⁰⁴⁶For a general discussion of the parties overseeing the debtor in possession in chapter 11, see Butler, et al., *supra* note 77. See also 11 U.S.C. § 1103 (detailing duties of statutory committees); *id.* § 1104 (appointment of trustee); *id.* § 1109 (explaining standing of parties in interest).

¹⁰⁴⁷See, e.g., Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119 ("The reason for such a low rate of committee formation [in SME cases] is that in most cases an insufficient number of creditors were willing to serve.").

¹⁰⁴⁸See H.R. Rep. No. 109-31, pt. 1, at 19 (2005), *reprinted* in 2005 U.S.C.C.A.N. 88, 89.

¹⁰⁴⁹See *Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Apr. 19, 2013) (ASM Transcript) ("[T]he case I worry about is th[e] case . . . with no committee and you have a debtor who is often lock-step with their secured creditor, because they have no choice but to be lock-step with their secured creditor, and there is nobody to tell me when there's a problem in the case."), *available at* Commission website, *supra* note 55; Blum, *supra* note 1032, at 199–201 ("[M]any small business debtors are left to operate too freely in chapter 11 without adequate control [by a unsecured creditors' committee].").

¹⁰⁵⁰This concept was a significant motivator for the BAPCPA reforms. Blum, *supra* note 1032, at 201 ("The central component of the proposed [BAPCPA] reform is the creation of an alternative monitoring system to compensate for lack of creditor involvement in the case. In essence, it demands a more aggressive role of the U.S. Trustee and the court as a substitute for the lack of creditor vigilance and increases the accountability of the [small business] debtor by placing greater responsibility on it to provide information about its business affairs and to move with reasonable speed in formulating and obtaining approval of its strategy for rehabilitation.") (citing NBRC Report, *supra* note 37, at 643).

financial guidance and counseling when needed. These factors allowed the Commissioners to reflect on various alternatives for structuring the SME principles, including a chapter 13-like process for SMEs.

Some Commissioners suggested that the best oversight for SME cases was a standing trustee system similar to that used in the chapter 13 context. In chapter 13 cases, the U.S. Trustee appoints a standing trustee in each jurisdiction. The trustee represents the estate, and he or she oversees the administration of the case, including the confirmation of, and distributions under, the debtor's rehabilitation plan. The trustee does not represent the debtor, but he or she may consult with the debtor, including with respect to issues in the proposed rehabilitation plan. A few Commissioners even suggested either raising the chapter 13 debt limits to permit small businesses to file under chapter 13 or incorporating a more chapter 13-like process into chapter 11 for small businesses.¹⁰⁵¹

Most Commissioners strongly rejected the notion of either a standing trustee for SMEs or a chapter 13-like process for SME cases. These Commissioners noted that small business cases are not simply big chapter 13 cases. They highlighted the structural differences in business cases, including the debtor's contractual relationships with vendors and suppliers and its obligations to customers. SMEs also have employees to consider and operational issues that may complicate their restructuring alternatives. Finally, these Commissioners highlighted the likely reluctance of SMEs to file bankruptcy cases if the administration of their cases and perhaps their businesses would be turned over to a standing trustee.

The Commissioners then considered whether the traditional unsecured creditors' committee structure was an effective oversight mechanism for SME cases. They reflected on the witness testimony concerning the costs associated with unsecured creditors' committees, particularly in smaller cases.¹⁰⁵² They also noted the creditor apathy that might prevent the formation of a committee in the first instance in SME cases.¹⁰⁵³ Most Commissioners agreed that committees could be effective in SME cases if creditors were engaged and representative of the general unsecured creditor body, and if costs could be contained. They also agreed, however, that satisfying both of these criteria in an SME case was likely the exception rather than the rule.¹⁰⁵⁴

The Commissioners analyzed whether an estate neutral might provide appropriate oversight in SME cases when a committee was not appointed and when the SME debtor needed monitoring or assistance.¹⁰⁵⁵ They reviewed the witness testimony on the types of tools that witnesses believed would be helpful to SME debtors. For example, the Honorable Barbara J. Houser of the U.S. Bankruptcy Court for the Northern

¹⁰⁵¹For a similar proposal that would create a process similar to chapter 12 for small business debtors, see Haines & Hendel, *supra* note 990.

¹⁰⁵²See *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (citing professionals' fees associated with unsecured creditors' committees as one of the bankruptcy process obstacles facing small business debtors), available at Commission website, *supra* note 55.

¹⁰⁵³See, e.g., Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119; Honorable A. Thomas Small, *Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305, 320–21, 320 n. 74 (1993) ("In most cases, however, unsecured creditors are apathetic and creditors' committees are ineffective, particularly in smaller Chapter 11 cases. Removing the creditors' committee would, however, benefit the debtor by eliminating the possibility that a creditors' committee might incur substantial professional fees that could easily jeopardize confirmation of the debtor's plan.").

¹⁰⁵⁴See *id.*

¹⁰⁵⁵See, e.g., *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) (stating that it could take an experienced turnaround professional only a few weeks to determine if a debtor's business is viable, whereas it would likely take an unassisted small business debtor much longer), available at Commission website, *supra* note 55; *Written Statement of the Honorable Melanie Cyganowski (Ret.)*, former Chief Bankruptcy Judge, Eastern District of New York: *CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Nov. 15, 2012) (noting there is very little oversight in most small business cases and that these cases seem to "live" from one emergency to the next), available at Commission website, *supra* note 55.

District of Texas suggested that “a third party who is more of a financial person, who could come in and evaluate the viability of the business,”¹⁰⁵⁶ may be of assistance to both the court and the debtor in possession in assessing the debtor’s prospects for reorganization. Several Commissioners observed that the estate-neutral concept might apply particularly well in SME cases. The court could appoint an estate neutral for specific purposes, including a financial review of the debtor, consulting with the debtor concerning its finances and restructuring options, or investigating the debtor’s affairs when necessary or appropriate. The estate neutral, with court authority, also could assist the SME debtor in developing its chapter 11 plan, which would provide oversight of the debtor in possession and a counterbalance to any particular individual creditor influence in the case. Although the estate neutral would impose an additional cost on the estate, the Commissioners believed that the courts could and should closely monitor the fees and expenses of the estate neutral and could even use caps or budgets to protect the estate.

On balance, the Commission voted to recommend the use of estate neutrals to assist SME debtors achieve effective outcomes in appropriate cases. The Commissioners underscored the case-by-case nature of this inquiry and, accordingly, declined to make it a mandatory appointment. They specifically found, however, that if the court orders the appointment of an estate neutral, the U.S. Trustee should be the party responsible for the appointment of the neutral to ensure objectivity and fairness in the process. The Commission also determined that the U.S. Trustee and parties in interest should be able to request the appointment of a committee in an SME case. As noted above, if there is creditor interest, a committee may be very valuable in an SME case. Nevertheless, the Commissioners found no basis for the existence (or non-existence) of a committee to affect an SME designation. They also believed that the cost of, and the historical issues with, appointing a committee in smaller cases supported a default rule of no committee appointment.

D. Plan Timeline in SME Cases

Recommended Principles:

- Within 60 days of the entry of the order for relief, the SME debtor should develop and file with the court a timeline for filing and soliciting acceptances of its plan.
- If an estate neutral or a committee is appointed, the SME debtor should consult with such estate neutral or committee in developing its timeline.
- After the SME debtor files its timeline for filing and soliciting acceptances of its plan, the court should enter an order under section 105(d)(2)(B) setting the deadlines for the SME debtor’s plan process.
- The SME debtor should be subject to the exclusivity periods provided in section 1121.

¹⁰⁵⁶Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 29 (Apr. 19, 2013) (ASM Transcript), available at Commission website, *supra* note 55.

Plan Timeline in SME Cases: Background

The Bankruptcy Code, as amended in 2005, requires that a debtor's chapter 11 plan be confirmed within 45 days of its filing. Several witnesses before the Commission testified that this is nearly impossible for small business debtors to achieve.¹⁰⁵⁷ Although it is possible to obtain a continuance, one witness noted that the burden for doing so is quite high, and that there is confusion regarding what the court must find and how it must make the necessary determinations, given the tight timelines and significant requirements.¹⁰⁵⁸ Thus, practically speaking, even viable small business debtors face considerable challenges to confirming a plan.

The Bankruptcy Code also provides that a small business debtor *must* file the chapter 11 plan within 300 days of the petition date.¹⁰⁵⁹ One witness noted that the 300-day deadline creates interpretive and practical problems similar to those identified above for the 45-day deadline, plus gives rise to additional concerns.¹⁰⁶⁰ For example, confusion exists regarding the application of the provision to parties other than the debtor, and the Bankruptcy Code does not specify the effect of an amended plan.¹⁰⁶¹ The Bankruptcy Code also does not address the consequences for failure to submit a plan by the 300-day deadline.¹⁰⁶²

Plan Timeline in SME Cases: Recommendations and Findings

The Commissioners debated the utility of firm deadlines in the context of SME cases. They understood the need to assess the viability of a debtor earlier rather than later in the case; no party benefits from prolonging a dismissal and incurring additional costs and expenses that cannot be paid. They also discussed the danger of handcuffing debtors to artificial deadlines that might not facilitate the debtor's reorganization or serve the interests of the estate in the particular case.

The Commission reviewed the recommendations of the advisory committee, which focused on helping both viable and nonviable debtors reach their fate efficiently. The advisory committee's recommendations included simplifying the definition of "small business debtor," and eliminating the 300-day plan proposal and 45-day plan confirmation deadlines for small business cases. The Commission also considered reforms suggested by witnesses, including more discretion for

¹⁰⁵⁷ *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), available at Commission website, *supra* note 55; *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("[E]ven when these [small and medium-sized] businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome."), available at Commission website, *supra* note 55.

¹⁰⁵⁸ *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–6 (Apr. 19, 2013), available at Commission website, *supra* note 55. See also 11 U.S.C. § 1129(e) (providing that the court shall confirm a plan within 45 days for small businesses, unless time is extended in accordance with section 1121(3)(3)); *id.* § 1121(e)(3) ("[T]he time periods . . . may be extended only if — (A) the debtor, after providing notice to parties in interest (including the United States trustee), demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (B) a new deadline is imposed at the time the extension is granted; and (C) the order extending time is signed before the existing deadline has expired.").

¹⁰⁵⁹ 11 U.S.C. § 1121(e) ("In a small business case . . . the plan and a disclosure statement (if any) shall be filed not later than 300 days after the date of the order for relief. . . .").

¹⁰⁶⁰ *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–7 (Apr. 19, 2013), available at Commission website, *supra* note 55.

¹⁰⁶¹ *Id.*

¹⁰⁶² Although the Bankruptcy Code does not address the consequences of the failure to file a plan within the 300-day period, "the consensus appears to be that if no party files a plan within the 300-day period, no relief can be afforded and the case must be dismissed." *Id.*

bankruptcy judges concerning the procedures in small business cases,¹⁰⁶³ and additional clarification regarding the standard of review and procedural requirements if the current 45- and 300-day confirmation and plan deadlines remain in place.¹⁰⁶⁴

The Commissioners worked to develop a process striking an appropriate balance between the need to assess the viability of an SME debtor case early while still allowing viable SME cases a reasonable opportunity to succeed. The Commission voted to recommend a mandatory requirement that the SME debtor file a timeline for filing and soliciting acceptances of its chapter 11 plan within 60 days of the petition date. It set this deadline to allow time for the SME debtor to settle into the chapter 11 case, resolve any issues relating to its SME designation, and consult with any committee or estate neutral appointed in the case, but still allow the court time to develop deadlines for the filing and solicitation of a chapter 11 plan consistent with other provisions of the Bankruptcy Code, such as the debtor's exclusivity periods under section 1121. The Commission determined that section 105(d)(2)(B) adequately authorizes the court to establish these deadlines, and that the Bankruptcy Code should be amended to simply require the court to exercise this authority in SME cases.

E. Plan Content and Confirmation in SME Cases

Recommended Principles:

- A chapter 11 plan in an SME case should provide for the following treatment of allowed claims and interests in the case:
 - o Payment of all administrative and priority claims in accordance with section 1129(a)(9) of the Bankruptcy Code.
 - o Bifurcation of each undersecured claim into an allowed secured claim in accordance with section 506 and a general unsecured claim for any deficiency claim; neither section 1111(b) nor section 1129(a)(7)(B) should apply in an SME case.
 - o Distributions to secured creditors (i) as provided in the plan and accepted by each class of secured creditors; or (ii) in accordance with section 1129(b)(2)(A).
 - o Distributions to unsecured creditors (i) as provided in the plan and accepted by each class of unsecured creditors; (ii) in accordance with section 1129(b)(2)(B) (subject to the recommended principles codifying

¹⁰⁶³ Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3 (Nov. 15, 2012) ("[I]t is essential that the Bankruptcy Court have flexibility to exercise judicial supervision regarding the SME debtor's business judgment when dealing with secured credit. The reasons are many but in most instances, these middle-market cases seemingly 'live' from one emergency to the next and therefore legislating 'fixed' criteria when it comes to the treatment of secured debt would not be in the best interest of promoting reorganization. It is not at all unusual in these middle-market Chapter 11 cases for a deadline or a budget requirement to be missed which, but for the Court's intervention and ability to step in and permit the waiver of an otherwise arbitrary provision, would lead to the automatic lifting of the automatic stay or the dismissal of the case without hearing or opportunity to be heard."), available at Commission website, *supra* note 55.

¹⁰⁶⁴ Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3–7 (Apr. 19, 2013), available at Commission website, *supra* note 55.

the new value corollary); or (iii) as provided below for an **SME Equity Retention Plan**. See Section VI.C.2, *New Value Corollary*.

- o Prepetition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that (i) all impaired classes have accepted the plan; (ii) the plan complies with section 1129(b) (subject to the recommended principles codifying the new value corollary); or (iii) the plan complies with section 1129(b)(2)(A) and provides impaired classes of unsecured creditors that have rejected the plan with preferred stock, or similar economic interests, in the reorganized debtor as described below (an “**SME Equity Retention Plan**”).
- The court should confirm an SME Equity Retention Plan that is not accepted by any class of unsecured claims only if:
 - o (i) The prepetition equity security holders will continue to support the debtor’s successful emergence from chapter 11 by remaining involved, on a basis reasonably comparable to their prepetition involvement, in the ongoing operations of the reorganized debtor; and (ii) the reorganized debtor will pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company’s operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. The debtor should file a budget with its disclosure statement and chapter 11 plan that describes the excess cash flow calculation method and includes projections of excess cash flow for the three fiscal years following the effective date of the plan.
 - o The prepetition equity security holders receive or retain 100 percent of the common stock, or similar ownership interests, issued or outstanding as of the effective date entitling the holders as a class to receive 15 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.
 - o The prepetition unsecured creditors as a class receive 100 percent of a class of preferred stock, similar preferred interests, or payment obligations issued by the reorganized debtor on the effective date in accordance with the chapter 11 plan with the following features (referred to as the “**creditors’ preferred interests**”): (i) *pro rata* voting rights, limited to voting only on the extraordinary transactions identified in these principles; and (ii) entitlement as a class to receive 85 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.
 - o The creditors’ preferred interests mature on the fourth anniversary of the effective date, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full

face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.

- o The following kinds of post-effective date transactions are deemed “*extraordinary transactions*” subject to the vote of holders of creditors' preferred interests: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) the sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. An extraordinary transaction should require at least an absolute majority vote of the holders of creditors' preferred interest, but the chapter 11 plan may require a higher level of approval. Whether an extraordinary transaction has been approved by the requisite majority vote (or such higher level as required by the plan) should be determined in accordance with applicable state entity governance law.
- o The consummation of an extraordinary transaction without the requisite approval should constitute a default under the chapter 11 plan, and holders of creditors' preferred interests should have the ability to request appropriate relief for such breach from the court that confirmed the plan. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.
- The general recommended principles proposed for chapter 11 plans apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

Plan Content and Confirmation in SME Cases: Background

Many commentators agree that chapter 11 is failing for small business debtors, but they disagree on both the cause and solution to this problem. As discussed above, some suggest that the deadlines concerning the plan process pose significant barriers. Others suggest that the plan process itself and the confirmation standards make emergence from chapter 11 almost impossible for small business debtors.¹⁰⁶⁵ Still, others have posited that reorganization is simply not feasible for small business debtors, benefits only the business owner, and that going concern sales may be a more effective restructuring option for these debtors.¹⁰⁶⁶

The Commission received testimony from several witnesses arguing that the absolute priority rule¹⁰⁶⁷ and courts' disparate treatment of the new value corollary doom many small business debtors' plans.¹⁰⁶⁸ As Judge Houser explained:

So, where a small to mid-sized business debtor cannot pay its unsecured claims in full with a market rate of interest over the life of the plan (a common occurrence), the junior class of interest holders may not receive or retain any property under the plan “on account of” their former interests. This is because of the application of what we call the absolute priority rule. The application of this rule and the so-called “new value exception” to it in small to mid-size Chapter 11 cases proves problematic.¹⁰⁶⁹

Witnesses suggested that this uncertainty in the plan process can cause delay and expense, and can even deter filings in the first instance.¹⁰⁷⁰

¹⁰⁶⁵*Id.* at 1 (“The complexity, time and costs of the Chapter 11 process impose obstacles that small businesses often cannot overcome.”); *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (“As Judge Dow has already observed, the complexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome. But, even when these businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome.”), available at Commission website, *supra* note 55.

¹⁰⁶⁶Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, 753, 786–89 (2002) (noting that Sweden’s insolvency code only provides for the sale of an insolvent firm and that it works well for both large and small businesses, and that many such small business debtors are run by “marginally competent owner-managers” with few corporate assets and few long-term employees). See also Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005) (“The typical Chapter 11 debtor is a small corporation whose assets are not specialized and rarely worth enough to pay tax claims. There is no business worth saving and there are no assets to fight over. The focal point is not the business, but the person who runs it.”).

¹⁰⁶⁷The absolute priority rule is implicated when there is an undersecured creditor who rejects the debtor’s plan. This undersecured creditor receives a lot of power in this circumstance because the creditor’s claim is bifurcated such that the creditor is able to vote in the secured class and the unsecured class. The small business debtor likely has only a few classes of claims. This ultimately makes the plan very difficult to confirm under the cramdown provisions. *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), available at Commission website, *supra* note 55.

¹⁰⁶⁸The new value exception presents problems in small business cases because there may be tension between the oversecured creditor and the owner-operators (equity security holders). These equity security holders may give new value to retain some stake in the reorganized business. However, there may be challenges in appropriately applying the new value exception in small business cases. *Id.* at 2–6.

¹⁰⁶⁹*Id.* at 2. See also *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) (“Inclusion of limited exclusivity and the implementation of the absolute priority rule in the bankruptcy regime make the most sense with respect to large public entities whose creditors and equity holders made informed investment decisions and understood their risk and relative priorities. I am not sure that the considerations are the same with respect to smaller businesses. Should entrepreneurs and families who are involved in the day to day operations of their businesses be provided some level of protection not available to holders of securities in public companies?”), available at Commission website, *supra* note 55.

¹⁰⁷⁰*Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) (suggesting that small businesses that are managed by equity security holders delay filing because of the personal financial detriment that such filings will cause them), available at Commission website, *supra* note 55.

Plan Content and Confirmation in SME Cases: Recommendations and Findings

A debtor's emergence from chapter 11 frequently turns on its ability to confirm a chapter 11 plan. Although it may consider a sale of all or substantially all of its assets under section 363x as an exit strategy, a debtor — particularly an SME who likely has founders or managers as part of its prepetition ownership structure — strives to reorganize and emerge from chapter 11 as a stronger and more efficient version of its prepetition business.

The Commission considered at length the interests of an SME's prepetition stakeholders and the challenges to confirmable plans for SME debtors.¹⁰⁷¹ The Commissioners acknowledged that many SMEs are family-owned businesses or businesses in which the founders are still actively involved.¹⁰⁷² For this reason, many SMEs find the common result of plan confirmation extinguishing prepetition equity interests in their entirety unsatisfactory or completely unworkable. The Commissioners discussed the tension created by these expectations: prepetition equity views their contributions and continued participation as necessary to the reorganization, but stakeholders may hold a very different perspective. Prepetition equity or managers may be considered part of the problem or ineffective.

The Commissioners debated how best to mitigate this tension and foster a meaningful reorganization process for SMEs. Most Commissioners agreed that the SME principles should include some option for prepetition equity security holders to retain or receive the equity of the reorganized debtor, beyond that currently permitted under the new value corollary. These Commissioners asserted that SMEs needed a reorganization path that encouraged founders and prepetition equity not only to invoke chapter 11, but also to devote all of their efforts to the debtor's successful reorganization. Indeed, for many SMEs — whether stakeholders like them or not — the prepetition founders or managers often possess the knowhow and relationships necessary to facilitate a successful restructuring of the business.¹⁰⁷³

The Commissioners determined that the SME principles should create an equity retention structure that would appropriately align the interests of prepetition management and equity with the debtor's reorganization and protect the interests of unsecured creditors, despite noncompliance with the traditional absolute priority rule. The basic elements of this structure include:

- A reorganized capital structure that (i) permits prepetition equity to retain or receive 100 percent of the voting interests in the reorganized debtor, subject to the limited voting rights of the creditors' preferred interests, and no more than 15 percent of the economic ownership interests in the reorganized debtor (akin to common stock ownership

¹⁰⁷¹ See, e.g., *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–6 (Apr. 19, 2013) (discussing how the absolute priority rule and the new value exception create challenges in the bankruptcies of owner-operated small businesses), available at Commission website, *supra* note 55.

¹⁰⁷² See, e.g., *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Nov. 3, 2012) (“While it is beneficial that value is being realized for creditors, the blood, sweat and tears of the owners are not being accorded the [appropriate] considerations [which affect the use of chapter 11 by small businesses].”), available at Commission website, *supra* note 55.

¹⁰⁷³ *Written Statement of Maria Chavez-Ruark: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 7, 2012) (“[I]n smaller Chapter 11 proceedings the debtor's competitive advantage is [often] based on the owners' relationships with customers, suppliers or others.”), available at Commission website, *supra* note 55.

with limited economic rights); and (ii) grants preferred ownership interests to general unsecured creditors that include limited voting rights on extraordinary transactions and at least 85 percent of the economic ownership interests in the reorganized debtor (creditors' preferred interests).

- A provision in the plan that directs the reorganized debtor to pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. This provision is intended to provide cash dividends to unsecured creditors prior to maturity of the preferred interests and to fairly allocate the reorganized debtor's excess cash to claims impaired by the chapter 11 plan.
- The creditors' preferred interests mature on the fourth anniversary of the effective date of the chapter 11 plan, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.
- The holders of creditors' preferred interests are entitled to vote on any and all of the following extraordinary transactions: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. This provision is intended to protect the value of, and entitlement to, the cash, creditors' preferred interests, and other distributions allocated to unsecured creditors under the plan from diminution or impairment by the postconfirmation actions of common interest-holders, managers, or insiders. The failure to adhere to the voting or other rights granted to holders of creditors' preferred interests under or in connection with the plan constitutes a default under the plan that may be enforced in the bankruptcy court. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under

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the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.

- Finally, the prepetition equity must commit to support the plan, the debtor's emergence from chapter 11, and its postconfirmation operations.

The Commission voted to recommend an equity-retention plan structure built on these basic elements. It believed that such a structure will provide appropriate incentives and protections, basically giving prepetition equity security holders four years after confirmation to repay the business's prepetition unsecured creditors. If the prepetition equity security holders are not able to achieve this result in that time period, then the unsecured creditors may convert their preferred interests into common ownership interests, significantly diluting the common ownership held by the prepetition equity security holders. Under this structure, both prepetition equity security holders and unsecured creditors have incentives to foster a sustainable and profitable reorganized business.

Finally, the Commissioners recommended other modifications to the section 1129(a) confirmation standards, including a mandatory bifurcation of undersecured creditors' claims so that only the allowed secured claim of such creditor would be subject to the cramdown requirements of section 1129(b)(2)(A), and its unsecured deficiency claim would be subject to the treatment provided general unsecured creditors. In addition, certain other modifications proposed by these principles to plan confirmation requirements for all chapter 11 cases would apply to SME cases, such as the elimination of an accepting impaired class of creditors under section 1129(a)(10). Notably, the Commission did not recommend application of the redemption option value principles to SME cases.¹⁰⁷⁴

¹⁰⁷⁴For a discussion of the redemption option value principles and the potential challenges to applying them in SME cases, see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.



VIII. PROPOSED RECOMMENDATIONS: STANDARD OF REVIEW AND KEY DEFINITIONS

A. General Standard of Review

Recommended Principles:

- The burden of proof in all matters under title 11 of the U.S. Code should be the preponderance of the evidence standard unless otherwise expressly stated in the applicable section of the Bankruptcy Code. Accordingly, section 102 of the Bankruptcy Code should be amended to clarify this point.

General Standard of Review: Recommendations and Findings

Throughout its study of chapter 11, the Commission identified multiple instances of courts adopting a different standard of review — either the preponderance of the evidence, or the clear and convincing standard — for the same issue under the same section of the Bankruptcy Code. The Bankruptcy Code is silent on the appropriate standard of review in these instances. The Commission thoroughly vetted the standard of review in connection with each of the substantive issues addressed in the Report. The Commission also considered related issues that were not being specifically discussed in the principles, but that also invoked a split in the courts concerning the appropriate standard of review. The Commission voted to recommend that the general standard of review in chapter 11 cases be the preponderance of the evidence standard, unless the Bankruptcy Code section specifically notes otherwise. The Commission has recommended principles for each instance in which it has determined that the clear-and-convincing standard is necessary and more appropriate.

B. Key Definitions and Concepts in Principles

The following definitions and concepts, among others, are used in the recommended principles. This section provides only (i) a summary of the definitions and (ii) cross-references for the concepts. Readers should consult each identified section of the Report for a complete explanation of these definitions and concepts.

“chapter 11 professional”

This concept is described in Section IV.A.7, *Professionals and Compensation Issues*.

“commercially reasonable determinants of value”

Determinants of value specified in the contract that are not manifestly unreasonable or, in the absence of such determinants of value, commercially reasonable market prices.

See Section IV.E.4, *Section 562 and “Commercially Reasonable Determinants of Value.”*

“creditors’ preferred interests”

This concept is described in Section VII.E, *Plan Content and Confirmation in SME Cases*.

“estate neutral”

This concept is described in Section IV.A.3, *The Estate Neutral*.

“executory contract”

A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other, provided that forbearance should not constitute performance.

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

“foreclosure value”

The net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor’s collateral under applicable nonbankruptcy law.

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

“milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions”

Tasks or conditions that relate in a material or significant way to the debtor’s operations during the chapter 11 case or to the resolution of the case, including deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and a chapter 11 plan.

See Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*.

“nonbankruptcy professional”

An individual or firm of lawyers, financial advisors, accountants, consultants, or other professionals retained by the debtor prior to or after the petition date working exclusively on business or legal matters that arise in, or relate primarily to, the day-to-day operations of the debtor’s business and that could not have a material effect on the chapter 11 case.

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

“permissible extraordinary financing provisions”

(i) Milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions; (ii) representations regarding the validity or extent of the creditor’s liens on the debtor’s property or property of the estate; or (iii) if some or all of the proposed postpetition lenders hold prepetition debt that would be affected by the postpetition facility, a provision that refinances prepetition debt with proceeds of the postpetition facility that is otherwise permissible under the principles relating to postpetition financing terms.

See Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*.

“redemption option value”

The redemption option value attributable to such immediately junior class is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period.

See Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

“redemption period”

The period between the plan effective date or sale order date and the third anniversary of the petition date.

See Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

“redemption price”

Where the senior class would otherwise be entitled to the entire value of the firm, the redemption price of the hypothetical option would be the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option.

See Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

“rent”

Any recurring monetary obligations of the debtor under the lease.

See Section V.A.6, *Real Property Leases*.

“reorganization value”

(i) If the debtor is reorganizing under the plan, the enterprise value attributable to the reorganized business entity, plus the net realizable value of its assets that are not included in determining the enterprise value and are subject to subsequent disposition as provided in the confirmed plan; or (ii) if the debtor is selling all or substantially all of its assets under section 363x or a chapter 11 plan, the net sale price for the enterprise plus the net realizable value of its assets that are not included in such sale and are subject to subsequent disposition as provided in the confirmed plan or as contemplated at the time of the section 363x sale.

See Section VI.C.1, *Creditors’ Rights to Reorganization Value and Redemption Option Value*.

“section 363x sale”

This concept is described in Section VI.B, *Approval of Section 363x Sales*.

“small or medium-sized enterprise” (“SME”)

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.

See Section VII.A, *Definition of SME*.

“SME Equity Retention Plan”

This concept is described in Section VII.E, *Plan Content and Confirmation in SME Cases*.

“valuation information package” (“VIP”)

- (i) Tax returns for the previous three years (inclusive of all schedules); (ii) annual financial statements (audited if available) for the prior three years (inclusive of all footnotes); (iii) most recent independent appraisals of any of the debtor’s material assets (including any valuations of business enterprise or equity); and (iv) to the extent shared with prepetition creditors and existing or potential purchasers, investors, or lenders, all business plans or projections prepared within the past two years.

See Section IV.A.6, *Valuation Information Packages*.

“value differential”

This concept is described in Section IV.B.1, *Adequate Protection*.



IX. OTHER ISSUES RELATING TO CHAPTER 11 CASES

A. Venue of Chapter 11 Cases

The Commissioners engaged in extensive deliberations concerning the existing venue statute, the merits of the venue debate, and the potential advantages and disadvantages to reforming the statute. These deliberations included an analysis of the reported case law on chapter 11 venue, the academic research, and the various reforms proposed by commentators and policymakers to address some or all of the alleged deficiencies in the venue statute. The Commissioners found these issues among some of the most difficult and divisive issues considered during the Commission project. Although all Commissioners appreciated and understood the various perspectives represented in the debate, they were unable to reach a consensus regarding whether reform of the venue statute was necessary or what potential reform might best serve the diverse interests in chapter 11 cases. Ultimately, the Commission concluded that it could contribute most meaningfully to the ongoing dialogue concerning chapter 11 venue by providing this summary of its research and deliberations.

Section 1408 of title 28 of the U.S. Code generally provides that a bankruptcy case may be filed in a jurisdiction where the debtor is domiciled or maintains its residence, principal place of business, or principal assets.¹⁰⁷⁵ In addition, the case may be filed in the same jurisdiction as a previously filed case of the debtor's affiliate, general partner, or partnership (the "affiliate-filing rule").¹⁰⁷⁶ Although not an issue unique to chapter 11 cases, disputes concerning the application of the venue statute arise most frequently in the chapter 11 context.¹⁰⁷⁷

The primary venue options for a business debtor are the debtor's domicile (*i.e.*, place of incorporation),¹⁰⁷⁸ principal place of business, location of principal assets, and place of an affiliate's filing. Particularly for larger businesses, each of these four locations may be a viable venue option. The debtor may be incorporated in one state, with its headquarters in another state and its principal assets in multiple states and jurisdictions. Likewise, its affiliated businesses may have multiple venue options that then become effectively available to the debtor under the affiliate-filing rule.

The venue selected by a business debtor in a voluntary chapter 11 filing often depends on several relevant factors. These factors include: (i) the proximity of the venue to the debtor's professionals, key creditors, and management; (ii) the legal precedent in the jurisdiction on potentially key issues in the debtor's restructuring efforts; and (iii) the facts available to support the filing of the case in a particular jurisdiction under the venue statute. In addition, a debtor also may consider the perceived expertise of the bankruptcy judges and the efficiencies of the processes available in potential venue jurisdictions.¹⁰⁷⁹

¹⁰⁷⁵28 U.S.C. § 1408.

¹⁰⁷⁶*Id.* See also *In re Patriot Coal Corp.*, 482 B.R. 718 (Bankr. S.D.N.Y. 2012).

¹⁰⁷⁷See, e.g., *In re Enron Corp.*, 274 B.R. 327 (Bankr. S.D.N.Y. 2002) (holding that venue was proper in the Southern District of New York, even though none of the debtors' core operations were located in New York, none of the debtors were organized under the laws of New York, a significant portion of the then current or former officers of the debtors resided in the Southern District of Texas, and substantially all of the debtors' books and records were located in Houston, Texas).

¹⁰⁷⁸See Barry E. Adler & Henry N. Butler, *On the "Delawarization of Bankruptcy" Debate*, 52 Emory L. J. 1309, 1311 (citing *In re Ocean Props. of Del., Inc.*, 95 B.R. 304, 305 (Bankr. D. Del. 1988)).

¹⁰⁷⁹See Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 Nw. U. L. Rev. 1357, 1359, 1389–90 (2000) (noting that counsel may advise debtors to choose Delaware because of the bench's experience and the attending increase in certainty).

A party in interest who disagrees with the debtor's venue selection, or simply believes that another venue is more convenient for the parties, may file a motion to transfer venue of the case to another jurisdiction or, in certain circumstances, to dismiss the case. Specifically, section 1412 of title 28 provides that "[a] district court may transfer a case or proceeding under title 11 to a district court for another district, in the interest of justice or for the convenience of the parties."¹⁰⁸⁰ Section 1406 of title 28 provides, in turn, that "[t]he district court of a district in which is filed a case laying venue in the wrong division or district shall dismiss, or if it be in the interest of justice, transfer such case to any district or division in which it could have been brought." Despite these statutory provisions, relatively few motions to transfer venue or to dismiss cases based on venue are filed.¹⁰⁸¹

The dearth of venue motions is in stark contrast to the long-running, high-profile debate concerning the utility of the existing venue statute. Beginning in the 1990s, some academics, practitioners, and judges began to question venue choices by large chapter 11 debtors and calling for the reform of section 1408 of title 28. This debate focused on the large concentration of business bankruptcies being filed in the Southern District of New York in the 1980s, in the District of Delaware in the 1990s, and in both of these two jurisdictions since that time. Some commentators estimate that approximately 70 percent of all large, public company chapter 11 cases are now filed in either the Southern District of New York or the District of Delaware.¹⁰⁸²

Critics of the existing venue statute argue that business debtors may use the venue rules to file cases in jurisdictions thousands of miles away from the company's management, employees, communities, and key constituencies, making it difficult and expensive for these parties to participate in or even follow the chapter 11 case.¹⁰⁸³ Critics also point out that the venue selected often appears to bear no meaningful relationship to the business, its operations, its financial difficulties, or its stakeholders.¹⁰⁸⁴ In addition, some critics also argue that the fees and publicity associated with large chapter 11 cases has led certain jurisdictions to cater to these types of debtors, encouraging businesses to file in their jurisdictions and creating a "race to the bottom" in chapter 11 practice.¹⁰⁸⁵ The two reforms most

¹⁰⁸⁰28 U.S.C. § 1412. See also *In re Patriot Coal Corp.*, 482 B.R. 718, 744 (Bankr. S.D.N.Y. 2012) (granting motion for venue transfer in the interest of justice and noting that although the debtors had complied with the letter of the law, the court "cannot allow the Debtors' venue choice to stand, as to do so would elevate form over substance in way that would be an affront to the purpose of the bankruptcy venue statute and the integrity of the bankruptcy system"); *Bankruptcy Court Transfers Venue of Patriot Coal Chapter 11 Cases from SDNY to St. Louis in the Interest of Justice*, Weil Bankruptcy Blog (Nov. 28, 2012), available at <http://business-finance-restructuring.weil.com/venue/bankruptcy-court-transfers-venue-of-patriot-coal-chapter-11-cases-from-sdny-to-st-louis-in-the-interest-of-justice/>.

¹⁰⁸¹Lynn M. LoPucki & William C. Whitford, *Venue Choice and Forum Shopping in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 1991 Wis. L. Rev. 11, 23–24 (1991) (noting that even if a case is filed in an improper venue, the case may not be transferred unless a party in interest files a motion, and even then, it is unclear if the court is obligated to transfer venue).

¹⁰⁸²See Marcus Cole, *'Delaware Is Not A State': Are We Witnessing Jurisdictional Competition in Bankruptcy?*, 55 Vand. L. Rev. 1845, 1850 (2002); Gordon Bermant, et al., Chapter 11 Venue Choice by Large Public Companies 38–42 (Federal Judicial Center ed. 1997).

¹⁰⁸³There is a value to stakeholders in having locally held proceedings. See *Gulf Oil Corp. v. Gilbert*, 330 U.S. 501, 509 (1947) ("In cases which touch the affairs of many persons, there is reason for holding the trial in their venue and reach rather than in remote parts of the country where they can learn of it by report only. There is a local interest in local controversies decided at home.").

¹⁰⁸⁴Theodore Eisenberg & Lynn M. LoPucki, *Shopping for Judges: An Empirical Analysis of Venue Choice in Large Chapter 11 Reorganizations*, 84 Cornell L. Rev. 967, 1001–02 (1999) (finding, through empirical research, that the reasons offered for venue choice — efficiency and convenience — are not supported by the data, and concluding that New York and Delaware are chosen either for the expertise of their bankruptcy judges or to avoid the debtor's local bankruptcy judge).

¹⁰⁸⁵Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom"*, 54 Vand. L. Rev. 231, 231, 235 (2001) (concluding that companies overwhelmingly chose Delaware as a bankruptcy venue because they lacked sufficient information about alternatives).

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frequently proposed by critics are the elimination of venue based on place of incorporation¹⁰⁸⁶ and on the affiliate-filing rule.¹⁰⁸⁷

Supporters of the existing venue statute argue that its flexibility allows business debtors to select the jurisdiction that will facilitate the most effective and value-maximizing reorganization.¹⁰⁸⁸ They observe that many businesses are geographically diverse, with operations, management, employees, and stakeholders dispersed throughout the country (and often overseas).¹⁰⁸⁹ There may not be one particular jurisdiction that is better or more convenient for the business and all stakeholders.¹⁰⁹⁰ They also note that the Southern District of New York and the District of Delaware are typically convenient for most businesses' financial creditors, have expertise in complex financial and operational matters, and have relatively efficient procedures for handling large cases.¹⁰⁹¹ Moreover, they find value in place of incorporation as a potential venue option because it is easy to identify and it is known, or knowable, by all stakeholders *ex ante*.¹⁰⁹²

The academic and empirical literature on venue selection is as diverse as the debate itself.¹⁰⁹³ Professor Lynn LoPucki suggests that venue selection may result in a higher repeat filing rate.¹⁰⁹⁴ Other commentators have reached different conclusions.¹⁰⁹⁵ Moreover, one study found that when corporate debtors file in New York or Delaware, creditors receive approximately 25 percent less than those of debtors filing their cases elsewhere.¹⁰⁹⁶ Another empirical study of the 159 largest

1086See NBRC Report, *supra* note 37, at 719 § 3.1.5 (recommending that 28 U.S.C. § 1408(1) be amended "to prohibit a corporate filing for relief in a district based solely on the debtor's incorporation in the state where that district is located").

1087See *id.* (suggesting that the affiliate-filing rule be reconfigured such that the affiliate may file in the same location where the parent has filed for bankruptcy, but not vice-versa unless venue is otherwise appropriate for the parent). See also Chapter 11 Bankruptcy Venue Reform Act of 2011, Hearing Before the H. Subcommittee on Courts., 112th Cong. 61 (2011) (statement of Professor Melissa B. Jacoby, University of North Carolina Chapel Hill) ("In bankruptcy, a major corporation also can follow a small subsidiary into a district in which the rest of the company has no relationship. *Enron* took this path. This practice has no intentional analogue in other federal venue rules. Indeed, to the extent that a plaintiff claims that a parent 'resides' in a district merely because its subsidiary is deemed to reside there for purposes of personal jurisdiction, the parent is likely to raise objections.") (citations omitted), available at http://judiciary.house.gov/_files/hearings/printers/112th/112-88_68185.PDF.

1088Rasmussen & Thomas, *supra* note 1079, at 1359.

1089See, e.g., Written Statement of James L. Patton, Jr., Esq., Young Conaway Stargatt & Taylor LLP: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2–6 (Nov. 22, 2013), available at Commission website, *supra* note 55.

1090See, e.g., Written Statement of Michael Luskin on Behalf of the New York City Bar Association's Comm. on Bankruptcy and Corporate Reorganization: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2 (Nov. 22, 2013), available at Commission website, *supra* note 55.

1091Rasmussen & Thomas, *supra* note 1079, at 1371; Kenneth Ayotte & David A. Skeel, Jr., *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, 73 U. Chi. L. Rev. 425, 453 (2006) (finding that Delaware bankruptcy courts are quite efficient as they handle cases more quickly and do not interfere with the firm's decisionmaking processes); David A. Skeel, Jr., *What's So Bad About Delaware?*, 54 Vand. L. Rev. 309 (2001) (arguing that firms benefit from Delaware incorporation and bankruptcy proceedings); David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. Cin. L. Rev. 1243 (2000) (arguing that Delaware venue in bankruptcy offers some of the benefits Delaware offers in corporate law).

1092Cole, *supra* note 1082, at 1905.

1093Bermant, *supra* note 1082; Adler & Butler, *supra* note 1078; Ayotte & Skeel, *An Efficiency-Based Explanation for Current Corporate Reorganization Practice*, *supra* note 1091; Eisenberg & LoPucki, *supra* note 1084; LoPucki & Kalin, *supra* note 1085; LoPucki & Whitford, *supra* note 1081; Cole, *supra* note 1082; Parikh, *Modern Forum Shopping in Bankruptcy*, *supra* note 1083; Rasmussen & Thomas, *supra* note 1079; Skeel, *What's So Bad About Delaware?*, *supra* note 1091; Skeel, *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, *supra* note 1091; Skeel, *Bankruptcy Judges and Bankruptcy Venue*, *infra* note 1100.

1094See Lynn M. LoPucki, *Courting Failure: How Competition for Big Cases Is Corrupting the Bankruptcy Courts* 100 *tbl.4* (2005).

1095See Robert K. Rasmussen, *Empirically Bankrupt*, 2007 Colum. Bus. L. Rev. 179, 221–26 (2007) ("The problem is obvious. Companies that reorganized in Delaware need a second reorganization at rates substantially higher than companies that reorganized elsewhere. This difference is statistically significant. . . . LoPucki has defined his population so that he could conduct a census rather than take a sample. . . . These tables reveal that the Delaware refiling effect that forms the heart of LoPucki's normative conclusion is really a prepackaged refiling effect.")

1096See Patrick Fitzgerald, *Bankruptcy Venue Change Linked to Recovery Rates*, Wall St. J. (Jan. 24, 2007) (citing an academic study completed by Wei Wang in 2007 titled "Bankruptcy Filing and the Expected Recovery of Corporate Debt," which reviewed 182 companies that filed for bankruptcy from 1995 to 2003, used trading prices of distressed debt as a measure of creditors' recoveries, and found that when debtors filed their case in New York or Delaware, creditors of those firms recovered around 25 to 35 percent less than those of firms that filed their cases elsewhere; the study offered to explain the disparity by the large proportion of fraudulent bankruptcies that were filed in New York and led to lower recoveries), available at <http://online.wsj.com/article/SB116961550859886124.html>.

bankruptcy cases between June 7, 2007, and June 30, 2012, found that 69 percent of those cases involved venue selection, which the article defined as “forum shopping.”¹⁰⁹⁷ This study asserts that venue selection leads to disparate treatment and undermines the perception and integrity of the bankruptcy system.¹⁰⁹⁸

Since the 1990s, several reform proposals have been discussed as part of the debate. For example, some suggest that statutory standards should be tightened and judicial discretion regarding venue should be narrowed.¹⁰⁹⁹ Others suggest altering the bankruptcy judge selection process or giving bankruptcy creditors a direct say in the forum selection process.¹¹⁰⁰ Still others suggest loosening the forum selection provision, claiming that venue choice should be further encouraged rather than discouraged.¹¹⁰¹ The National Bankruptcy Review Commission recommended requiring a bankruptcy filing where the principal assets are located and, if this location is undeterminable, then where the principal place of business is located.¹¹⁰² In 2005, Senator John Cornyn proposed changes to the venue provisions.¹¹⁰³ The bill was introduced to address the venue-choice issues raised in cases such as *Enron*, *K-Mart*, *Polaroid*, and *WorldCom*; this proposal would have amended section 1408 to prevent a debtor from filing in a district where the debtor is incorporated, unless that district was also the debtor’s principal place of business.¹¹⁰⁴ Testimony supporting the bill suggested that because corporations identify strongly with communities, to have an iconic company file in a venue other than in that community undermines the judicial process, and further, that the current transfer of venue statute is ineffective.¹¹⁰⁵

Notably, the testimony before the Commission reflects the diversity of perspectives evidenced by the historical debate and reform proposals. The Honorable Steven Rhodes of the U.S. Bankruptcy Court for the Eastern District of Michigan has stated that venue choice has a negative impact on judicial legitimacy, especially when it prevents or impairs the meaningful participation of any of the parties, ultimately undermining the integrity of the adjudication process itself.¹¹⁰⁶ Another witness expressed a similar sentiment: “The unspoken but implicit message in a filing across the country

1097 Parikh, *supra* note 1083, at 159, 177. A debtor was deemed to have “forum shopped” based on a review of the debtor’s bankruptcy petition and analysis of its basis for establishing venue in a particular district in light of supporting documentation, like first-day motions. The study found that over a two-decade period, the frequency with which large corporate debtors forum shopped increased 14 percent and the absolute number of such debtors who forum shopped increased 130 percent. *Id.* at 159, 177–78.

1098 *See id.* at 198 (“A cornerstone of our judicial system is that the law be subject to a variety of interpretations at the trial level. . .”).

1099 *See* LoPucki & Whitford, *supra* note 1081, at 11 (recommending tighter statutory standards and narrower judicial discretion).

1100 David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 Del. L. Rev. 1, at 4–5 (1998).

1101 Rasmussen & Thomas, *supra* note 1079, at 1359 (arguing that venue choice should be encouraged, perhaps even prior to experiencing financial distress; considering venue choice in advance, they argue, would allow managers to choose the forum most likely to maximize the value of the firm).

1102 NBRC Report, *supra* note 37, at 719.

1103 Fairness in Bankruptcy Litigation Act of 2005, S. 314, 109th Cong. (2005).

1104 *See* Jeffrey Morris, S. 314—Fairness in Bankruptcy Litigation Act of 2005: Restricting Venue Choices for Corporate Debtors, Am. Bankr. Inst. (Mar. 1, 2005), available at <http://www.abiworld.org/AM/Template.cfm?Section=Home&CONTENTID=40272&TEMPLATE=/CM/ContentDisplay.cfm>.

1105 H.R. 2533: Chapter 11 Bankruptcy Venue Reform Act of 2011, Hearing Before the H. Subcomm. On Courts, Commercial and Administrative Law, 112th Cong. 30–31 (Sept. 8, 2011) (statement of the Honorable Frank J. Bailey, Chief Judge of the U.S. Bankruptcy Court for the District of Massachusetts) (stating that a big business bankruptcy should be filed in its “community” and that the transfer of venue statute is not effective because “[i]t is enormously expensive for a party to mount a challenge to venue”). On the other hand, the Commissioners reviewed information indicating that when venue transfer motions are filed, they are often granted. *See, e.g.,* Written Statement of James L. Patton, Jr., Esq., Young Conaway Stargatt & Taylor LLP: UT Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 2–6 (Nov. 22, 2013) (“From 2006 through 2012, however, motions to transfer venue out of Delaware bankruptcy court were ruled upon by the bankruptcy court in 13 different non-affiliated chapter 11 cases. In nine of these 13 different chapter 11 cases, or roughly 69.2 percent, the Delaware bankruptcy court transferred venue.”), available at Commission website, *supra* note 55.

1106 Written Statement of the Honorable Steven Rhodes, U.S. Bankruptcy Judge, E.D. Michigan: UT Field Hearing Before the ABI Comm’n to Study the Reform of Chapter 11, at 7–8 (Nov. 22, 2013), available at Commission website, *supra* note 55.

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from home base is that nobody counts but the lenders and the debtor's management."¹¹⁰⁷ Yet another witness decried venue choice, arguing that it "disenfranchises smaller and local parties in interest, erodes the credibility of the bankruptcy system and gives rise to the perception that the system is being manipulated."¹¹⁰⁸ Witnesses also defended the current venue statute, with one arguing that a change in the venue statute limiting venue to the principal place of business would only increase uncertainty and ultimately increase litigation regarding the location of the debtor's principal place of business and proper venue.¹¹⁰⁹ That witness also noted that the convenience of the parties may not necessarily be served by limiting venue to the principal place of business as creditors are often widely dispersed because of the global nature of the economy.¹¹¹⁰ Another witness defended the venue statute on the grounds that "[t]here is no reason to believe that the jurisdiction where a corporate parent is headquartered or holds its principal assets is always a more appropriate venue, or one more convenient to creditors."¹¹¹¹

B. Core and Noncore Matters in Chapter 11 Cases¹¹¹²

When Congress enacted the Bankruptcy Act of 1978, it conferred broad subject matter jurisdiction upon bankruptcy courts. Jurisdiction was granted over all "civil proceedings arising under title 11 or arising in or related to cases under title 11."¹¹¹³ Although the bankruptcy courts operated under the supervision of the district court under the former Bankruptcy Act as a matter of practice, they operated with considerable independence.

In 1982, the Supreme Court in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.* struck down the Bankruptcy Act of 1978's broad jurisdictional provisions, asserting that the Act unconstitutionally conferred Article III judicial power upon Article I bankruptcy judges.¹¹¹⁴ Article III, Section 1 of the U.S. Constitution provides that "[t]he judicial Power of the United States, shall be vested in one Supreme Court, and in such inferior Courts as the Congress may from time to time ordain and establish." Bankruptcy judges, without lifetime tenure and protections against salary diminution, are not created under Article III and so are not vested with the "judicial Power of the United States."

¹¹⁰⁷ Written Statement of Michael R. ("Buzz") Rochelle: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 6–7 (Nov. 22, 2013), available at Commission website, *supra* note 55. Mr. Rochelle also noted that perception matters on the issue of whether justice is being served, and having cases heard far from a business's community erodes that community's perception that justice is being done. *Id.* at 7. See also Written Statement of Lawrence J. Westbrook: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 1–3 (Nov. 22, 2013) (arguing that bankruptcy proceedings should be held in the business's community to increase the transparency of the proceedings and ultimately to improve the administration of justice (or at least the appearance of it)), available at Commission website, *supra* note 55.

¹¹⁰⁸ Written Statement of Douglas B. Rosner on behalf of the National Ad Hoc Group of Bankruptcy Practitioners in Support of Venue Fairness: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2 (Nov. 22, 2013), available at Commission website, *supra* note 55.

¹¹⁰⁹ Written Statement of James L. Patton, Jr., Esq., Young Conaway Stargatt & Taylor LLP: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2–6 (Nov. 22, 2013), available at Commission website, *supra* note 55.

¹¹¹⁰ *Id.* at 7.

¹¹¹¹ Written Statement of Michael Luskin on Behalf of the New York City Bar Association's Comm. on Bankruptcy and Corporate Reorganization: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 2 (Nov. 22, 2013), available at Commission website, *supra* note 55. Mr. Luskin also noted that technology has made it possible for far off parties to participate in proceedings via telephonic appearances. *Id.* at 4.

¹¹¹² Professor Lois Lupica, University of Maine School of Law, Robert M. Zinman ABI Resident Scholar (Fall 2014), drafted this section (*Core and Noncore Matters in Chapter 11 Cases*).

¹¹¹³ 28 U.S.C. § 1471(b).

¹¹¹⁴ *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982).

To address this problem and provide a “fix,” Congress enacted the Bankruptcy Amendments and Federal Judgeship Act of 1984. The 1984 jurisdictional scheme vested bankruptcy jurisdiction in the first instance in the district courts, deeming bankruptcy courts as units of the district court for each district.¹¹¹⁵ Pursuant to the 1984 Act, district courts may refer cases and matters within the scope of such jurisdiction to the bankruptcy courts. Once referred, whether a bankruptcy court may hear and render a final judgment on a matter in a bankruptcy case, absent the parties’ consent, turns on whether a matter is deemed to be core or noncore.

Title 28, Section 157(b) sets forth a nonexhaustive list of matters deemed to be core matters.¹¹¹⁶ Generally, these “core” matters are those with which the bankruptcy court has greater familiarity and expertise than the district court.¹¹¹⁷ Final orders with respect to core matters are subject to appellate review by the district courts or bankruptcy appellate panels.

In contrast, “noncore” proceedings are ones that have a “life of [their] own in either state or federal common law or statute independent of the federal bankruptcy laws.”¹¹¹⁸ The bankruptcy judge in noncore proceedings is limited to submitting proposed findings of fact and conclusions of law to the district court.¹¹¹⁹ Once such proposed findings and conclusions are submitted, the district court judge enters a final order or judgment.¹¹²⁰ The district court also conducts a *de novo* review

¹¹¹⁵28 U.S.C. § 151.

¹¹¹⁶Examples of core proceedings include but are not limited to:

- (A) matters concerning the administration of the estate;
- (B) allowance or disallowance of claims against the estate or exemptions from property of the estate, and estimation of claims or interests for the purposes of confirming a plan of reorganization but not the liquidation or estimation of contingent or unliquidated personal injury tort or wrongful death claims against the estate for purposes of distribution in a bankruptcy case;
- (C) counterclaims by the estate against persons filing claims against the estate;
- (D) orders in respect to obtaining credit;
- (E) orders to turn over property of the estate;
- (F) proceedings to determine, avoid or recover preferences;
- (G) motions to terminate, annul or modify the automatic stay;
- (H) proceedings to determine, avoid, or recover fraudulent conveyances;
- (I) determinations as to the dischargeability of particular debts;
- (J) objections to discharges;
- (K) determinations of the validity, extent, or priority of liens;
- (L) confirmations of plans;
- (M) orders approving the use or lease of property, including the use of cash collateral;
- (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate; and
- (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claim.

28 U.S.C. § 157(b)(2).

¹¹¹⁷*Artra Grp., Inc. v. Salomon Bros. Holding Co., Inc. (In re Emerald Acquisition Corp.)*, 170 B.R. 632 (Bankr. N.D. Ill. 1994).

¹¹¹⁸*Salomon v. Kaiser (In re Kaiser)*, 722 F.2d 1574, 1582 (2d Cir. 1983); *Bethlahmy, IRA v. Kuhlman (In re ACI-HDT Supply Co.)*, 205 B.R. 231 (B.A.P. 9th Cir. 1997); *Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld LLP*, 201 B.R. 635 (S.D.N.Y. 1996) (explaining that noncore matters are those in which the district court is more proficient than the bankruptcy court); *Scotland Guard Servs. v. Autoridad de Energia Electrica (In re Scotland Guard Servs., Inc.)*, 179 B.R. 764 (Bankr. D.P.R. 1993) (explaining that noncore proceedings, where the action “would survive outside of bankruptcy,” include causes of action by the debtor against a third party based on nonbankruptcy law).

¹¹¹⁹28 U.S.C. § 157(c)(1).

¹¹²⁰*See McFarland v. Leyh (In re Tex. Gen. Petroleum Corp.)*, 52 F.3d 1330, 1337 (5th Cir. 1995) (holding that district court must review bankruptcy court’s judgment *de novo*); *Moody v. Amoco Oil Co.*, 734 F.2d 1200 (7th Cir. 1984), *cert. denied*, 469 U.S. 982 (1984) (holding that a new trial is not required but the record should be examined without giving deference to proposed factual findings).

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of those matters to which a party has timely objected.¹¹²¹ Until recently, it has been understood that affirmative consent of the parties allows bankruptcy judges to conduct trials and enter final orders, whether or not a proceeding or matter is core or noncore.¹¹²²

Notwithstanding the enumerated list of core matters found in section 157(b), as a practical matter the distinction between core and noncore can be difficult to discern.¹¹²³ When a case or proceeding presents a mix of core and noncore claims, the bankruptcy court must perform a claim-by-claim analysis to determine the extent of its jurisdiction and authority.¹¹²⁴

The Supreme Court in *Stern v. Marshall* recently revisited bankruptcy judges' authority to hear and finally determine statutorily prescribed "core" matters under section 157(b).¹¹²⁵ In *Stern*, the Court addressed the question of whether a debtor's state law counterclaim was a core claim, and if so, whether the bankruptcy court had the authority to enter a final order. In a self-described "narrow" decision, the Supreme Court found that although the bankruptcy court had statutory authorization to enter a final judgment on the debtor's tortious interference counterclaim (as a core claim), the bankruptcy court lacked the constitutional authority to do so. This ruling opened the door to several questions, including (i) whether bankruptcy judges are statutorily authorized under 28 U.S.C. § 157(c) to propose findings of fact and conclusions of law in core proceedings, and (ii) whether Article III allows a bankruptcy court to enter a final judgment on a *Stern* claim, with the consent of the parties. The *Stern* decision has resulted in increased litigation.¹¹²⁶ In an effort to address these open issues (and resolve the Circuit Court splits), the Supreme Court recently heard two cases: *Executive Benefits Insurance Agency v. Arkinson*¹¹²⁷ and *Wellness International Network v. Sharif*.¹¹²⁸

In the *Arkinson* decision, the Supreme Court held that the reasoning of *Stern v. Marshall* constitutionally prohibits a bankruptcy court from entering final judgment on a bankruptcy "related to" claim (one deemed to be noncore); nevertheless, section 157(c) allows a bankruptcy court to issue proposed findings of fact and conclusions of law to be reviewed *de novo* by the district court.

The Supreme Court has not heard oral argument nor issued a decision in *Wellness Int'l Network v. Sharif*.¹¹²⁹ The Court is expected to address the open issue of whether bankruptcy courts can issue a final judgment in core matters where they lack constitutional authority (known as a *Stern* claim) if the parties expressly consent. Specifically, the Court certified two questions for consideration: (i) whether an action brought against a debtor to determine whether property in the debtor's possession

1121 "Timely" is defined as within 10 days of service of proposed findings of fact and conclusions of law. 28 U.S.C. § 157(c)(1); Fed. R. Bankr. P. 9033.

1122 See *Stern v. Marshall*, 131 S. Ct. 2594 (2011). See also *infra* note 1125 and the accompanying discussion. In an adversary proceeding, the complaint, counterclaim, cross-claim, or third party complaint must state whether the proceeding is core or noncore and, if noncore, it must affirmatively state whether each party consents to entry of a final order by the bankruptcy court. Fed. R. Bankr. P. 7008(a).

1123 See *In re U.S. Brass Corp.*, 110 F.3d 1261, 1268–69 (7th Cir. 1997) (finding that the impact of the claim on estate showed that it was "related to" the case and thus a noncore proceeding, rather than a core proceeding). See generally *Houbigant, Inc. v. ACB Mercantile, Inc.* (*In re Houbigant, Inc.*), 185 B.R. 680 (S.D.N.Y. 1995) (noting that a proceeding is core if it invokes a substantive right under the Bankruptcy Code or could arise only in a bankruptcy case).

1124 *Halper v. Halper*, 164 F.3d 830, 838–40 (3d Cir. 1999).

1125 *Stern v. Marshall*, 131 S. Ct. 2594 (2011).

1126 See *Written Testimony of the Honorable Joan N. Feeney: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–7 (Apr. 19, 2012) (describing delays and increases in costs as a result of the *Stern* decision, sometimes merely as a delay tactic), available at Commission website, *supra* note 55.

1127 *Exec. Benefits Ins. Agency v. Arkinson*, 133 S. Ct. 2880 (2014).

1128 *Wellness Int'l Network, Ltd. v. Sharif*, 727 F.3d 751 (7th Cir. 2013), *reh'g en banc denied*, (Oct. 7, 2013), *cert. granted in part*, 134 S. Ct. 2901 (2014).

1129 *Id.*

is property of the bankruptcy estate stems “from the bankruptcy itself” or whether such an action is outside of the bankruptcy court’s constitutional authority to enter a final order; and (ii) whether the parties’ consent allows the exercise of Article III judicial power by the bankruptcy courts, and if so, whether implied consent based on a litigant’s conduct is sufficient.¹¹³⁰

The Commission, and all those interested in the efficient operation of the U.S. bankruptcy system, look forward to further clarity with respect to the scope of the bankruptcy court’s authority to hear and finally determine bankruptcy-related issues.

C. Individual Chapter 11 Cases¹¹³¹

The number of chapter 11 cases filed by individuals has increased dramatically in recent years, rising steadily since 2006. Although chapter 11 has long been available to individuals,¹¹³² numerous BAPCPA modifications, coupled with a post-recession increase in the number of individuals needing the bankruptcy remedy but precluded from filing under chapter 13 because of statutory debt limits, have led to many question the adequacy and suitability of chapter 11 for individual debtors. The reform of those provisions in chapter 11 applicable to individual debtors was determined to be beyond the scope of the Commission’s charge. An ABI-sponsored study examining many of these individual chapter 11 issues, however, is currently underway.

The Individual Chapter 11 Study researchers will be examining the many questions arising in individual chapter 11 cases, and identifying the key issues in need of resolution. For example, BAPCPA’s expanded chapter 11 definition of “property of the estate” to incorporate an individual debtor’s earnings from services performed after the commencement of the case, but before the case is closed, dismissed or converted,¹¹³³ has resulted in uncertainty with respect to the allowable sources of payments to professionals.¹¹³⁴ In addition, whether funds from postpetition earnings ought to

¹¹³⁰Wellness Int’l Network, Ltd. v. Sharif, 134 S. Ct. 2901 (2014) (granting certiorari to Questions 1 and 3 presented by the petition); Petition for Writ of Certiorari, Wellness Int’l Network, Ltd. v. Sharif, 2014 WL 466827 (Feb. 5, 2014).

¹¹³¹Professor Lois Lupica, University of Maine School of Law, Robert M. Zinman ABI Resident Scholar (Fall 2014), drafted this section (*Individual Chapter 11 Cases*).

¹¹³²See 11 U.S.C. § 109(d) (“Only a person that may be a debtor under chapter 7 of this title, except a stockbroker or commodity broker, and a railroad may be a debtor under chapter 11 of this title.”). See also *Toibb v. Radloff*, 501 U.S. 157 (1991) (“[T]he Bankruptcy Code’s plain language permits individual debtors not engaged in business to file for relief under Chapter 11. Toibb is a debtor within the meaning of 109(d).”).

¹¹³³See 11 U.S.C. § 1115. Section 1115 provides, in relevant part:

(a) In a case in which a debtor is in individual, property of the estate includes, in addition to the property specified in section 541 –

(1) all property of the kind specified in section 541 that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 12 or 13, whichever occurs first; and
(2) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed or converted.

(b) Except as provided in section 1104 or a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

¹¹³⁴Section 330 of the Bankruptcy Code states that professionals may only be compensated from estate property if their services were reasonably likely to result in a benefit to the estate. If an individual chapter 11 debtor seeks to pay a professional during the pendency of his or her case, such as, for example, counsel to object to exemption objections or even a divorce attorney, the resulting professional’s fees arguably do not provide a benefit to the estate, and thus may not be paid from the debtor’s postpetition wages.

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be factored into a chapter 7 liquidation analysis, and how these funds in the estate's DIP account are disposed of in the event of a conversion to chapter 7, remain open questions.¹¹³⁵ Courts have grappled with these issues but have arrived at no consistent answers.

The “fit” of chapter 11 and all its complexity has also presented significant hurdles to individual debtors seeking reorganization. The Commission addressed the matter of chapter 11's complexity in the context of its *Proposed Recommendations for Small and Medium-Sized Enterprise Cases*,¹¹³⁶ and the past years' individual chapter 11 cases have illustrated the need to similarly attend to the issue of the efficiency of the process for individual debtors.¹¹³⁷ There have been improvised solutions to reduce administrative costs and burdensome deadlines by, for example, allowing an individual chapter 11 debtor to disclose the information required by section 1125 of the Bankruptcy Code in the chapter 11 plan document without the necessity of filing a separate disclosure statement. Some courts have also combined the plan/disclosure statement hearing with the confirmation hearing for individual chapter 11 debtors.¹¹³⁸ Model individual chapter 11 plan forms have been adopted in some jurisdictions in order to further streamline the plan development and confirmation process.¹¹³⁹ These *ad hoc* solutions illustrate the need for a comprehensive examination of the operation of chapter 11 in the context of individuals' cases.

Finally, the issue of the applicability of the absolute priority rule in individual chapter 11 cases¹¹⁴⁰ has been a fundamental-yet-troublesome issue addressed by the courts. Currently, there is no judicial consensus on whether (and to what extent) the BAPCPA Amendments abrogated the absolute priority rule by excepting postpetition property and earnings from amended 11 U.S.C. § 1129(b)(2)(B)(ii).¹¹⁴¹

Until these issues are addressed and definitively resolved, the utility of chapter 11 for individual debtors cannot be fully realized. The Individual Chapter 11 Study and Report will be released upon its completion.

1135A debtor's postpetition wages are deposited in the bankruptcy estate's DIP account, in a bank approved by the U.S. Trustee, unless the bankruptcy court orders otherwise for “cause.” 11 U.S.C. § 345(b) (2013). See *In re Service Merchandise Co., Inc.*, 240 B.R. 894 (Bankr. M.D. Tenn. 1999) (establishing a totality of the circumstances test to determine “cause”). Following conversion or dismissal of the case, it is not clear who has a claim to the DIP account proceeds — the debtor or the chapter 7 trustee.

1136See Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

1137See *In re Berko*, Case No. 12-33631, Docket No. 98 (Bankr. D.N.J. Sept. 24, 2013); *In re Tassel*, Case No. 10-11742-A-11, 2011 Bankr. LEXIS 5641 (Bankr. E.D. Cal. June 7, 2011).

1138See *In re Gulf Coast Oil Co.*, 404 B.R. 407, 425 (Bankr. S.D. Tex. 2009) (expressly recognizing that section 1125(f) “authorizes combined plans and disclosure statements in small business cases and § 105(d) authorizes the court to combine them in other cases”).

1139The U.S. Bankruptcy Court for the Southern District of Texas, www.txs.uscourts.gov/bankruptcy/individual_11_plan_example.pdf, and the U.S. Bankruptcy Court for the Northern District of California, www.canb.uscourts.gov/announcements/standardform-combined-plan-and-disclosurestatement-individual-chapter-11-debtors, are two such jurisdictions.

114011 U.S.C. § 1129(b)(2)(B)(ii).

1141See *In re Walsh*, 447 B.R. 45, 49 (Bankr. D. Mass. 2011); *In re Gelin*, 437 B.R. 435 (Bankr. M.D. Fla. 2010); *In re Gbadebo*, 431 B.R. 222, 228 (Bankr. N.D. Cal. 2010) (holding that BAPCPA abrogated the absolute priority rule only as to postpetition assets incorporated into the estate by section 1115); *In re Mullins*, 435 B.R. 352 (Bankr. W.D. Va. 2010); *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010) (holding that the absolute priority rule no longer applies in individual chapter 11 cases).

D. SIFIs and Single Point of Entry Schemes

Following the financial crisis of 2008, policymakers focused on the procedures for resolving financial distress at large financial institutions. Some commentators and policymakers asserted that the Federal Deposit Insurance Corporation (the “**FDIC**”) lacked effective tools for resolving these issues during the crisis.¹¹⁴² The result was Title II, Orderly Liquidation Authority (“**OLA**”), of the Dodd-Frank Act.¹¹⁴³ OLA established a new mechanism for resolving the failure of certain systemically important financial institutions (“**SIFIs**”) if it is determined that resolution under the Bankruptcy Code is not appropriate.¹¹⁴⁴

Commentators have raised concerns about how OLA would work in practice,¹¹⁴⁵ and several alternative and supplemental proposals have been advanced. The FDIC, which will act as a receiver in OLA cases, has proposed a “single point of entry” (“**SPOE**”) procedure to address these concerns. Many commentators suggest, however, that the Bankruptcy Code should be amended to reduce the likelihood that OLA will need to be invoked.¹¹⁴⁶

Notably, there are two proposals to amend the Bankruptcy Code to deal with failing SIFIs. The first was introduced in the U.S. Senate and proposes to add a new chapter 14 (chapter 14) to the Bankruptcy Code.¹¹⁴⁷ The second was introduced in the U.S. House of Representatives and proposes to add a subchapter V to chapter 11 (subchapter V) of the Bankruptcy Code.¹¹⁴⁸ As discussed below, the subchapter V proposal before the House and the chapter 14 proposal before the Senate are structurally similar. Both proposals would, for example, apply only to covered financial corporations

¹¹⁴²See *Regulation and Resolving Institutions Considered “Too Big to Fail” Hearing Before the Senate Committee on Banking, Housing, and Urban Affairs*, 111th Cong. 52 (May 6, 2009) (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corp.) (“In the case of a bank holding company, whether systemically significant or not, the FDIC has the authority to take control of only the failing bank subsidiary, thereby protecting the insured depositors. However, in some cases, many of the essential services for the bank’s operations lie in other portions of the holding company and are left outside of the FDIC’s control, making it difficult to operate and resolve the bank. . . . [W]here the holding company structure includes many bank and non-bank subsidiaries, taking control of just the bank is not a practical solution.”), available at <http://www.gpo.gov/fdsys/pkg/CHRG-111shrg53822/pdf/CHRG-111shrg53822.pdf>; Sir Jon Cunliffe, *Deputy Governor for Financial Stability of the Bank of England, Remarks at the Barclays European Bank Capital Summit* (May 13, 2014) (“Nowhere was failure more disruptive than for the liquidation of Lehman Brothers, where the FDIC lacked the requisite powers to resolve the firm in an orderly fashion. The process was disorderly, time consuming and expensive. And it was very contagious. . . . The FDIC estimates that, had a legal framework existed to put the firm through a resolution and receivership process, a quick resolution could have recovered far more value. . . .”), available at <http://www.bis.org/review/r140515b.htm>.

¹¹⁴³Dodd-Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. tit. II, §§ 201 *et seq.* (2010) [hereinafter *Dodd-Frank*], available at <https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf>; see also David A. Skeel, Jr., *Single Point of Entry and the Bankruptcy Alternative*, in *Across the Great Divide: New Perspectives on the Financial Crisis* 311 (Martin Neil Baily & John B. Taylor eds., 2014), available at http://scholarship.law.upenn.edu/faculty_scholarship/949.

¹¹⁴⁴ “[B]ecause the rights of creditors are significantly more limited under the orderly liquidation authority [than in bankruptcy], Title II requires that before the FDIC may be appointed as receiver of a financial company, a non-judicial evaluation [must] be made as to why a case under the Bankruptcy Code is not appropriate for the financial company.” Hollace T. Cohen, *Orderly Liquidation Authority: A New Insolvency Regime to Address Systemic Risk*, 45 U. Rich. L. Rev. 1143, 1151 (2011). See generally Thomas H. Jackson, *Resolving Financial Institutions: A Proposed Bankruptcy Code Alternative*, Banking Perspective, Mar. 2014, at 22; *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives*, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law, 113th Cong. 99 (2014) (statement of Thomas H. Jackson, Distinguished University Professor & President Emeritus of the University of Rochester) [hereinafter *Jackson Statement*], available at http://judiciary.house.gov/_cache/files/832fe54a-bf55-4567-8eeb-54cdcbec5e5e/113-90-87331.pdf.

¹¹⁴⁵See Stephen J. Lubben, *OLA After Single Point of Entry: Has Anything Changed?* (Seton Hall Public Law Research Paper No. 253035) (noting that if we push beyond the happy press releases trumpeting the wonder of single point of entry, we see what questions remain), available at <http://ssrn.com/abstract=2353035>.

¹¹⁴⁶Jackson Statement, *supra* note 1144, at 106 (recommending amending the Bankruptcy Code so that bankruptcy can serve as its intended role as the “primary resolution device” so that OLA under Dodd-Frank will be a “just in case” backup).

¹¹⁴⁷Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (1st Sess. 2013) [hereinafter *Chapter 14 Bill*], available at <https://www.govtrack.us/congress/bills/113/s1861/text>.

¹¹⁴⁸Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2d Sess. 2014) [hereinafter *Subchapter V Bill*], available at http://judiciary.house.gov/_cache/files/94c89efd-5d4c-46bc-bbec-a3b8c6f74f56/webhr-5421-financial-institution-bankruptcy-act.pdf.

and are intended to implement an SPOE-type process.¹¹⁴⁹ As drafted, only the Senate bill proposes to repeal OLA.¹¹⁵⁰

The FDIC's Single Point of Entry Procedure for Orderly Liquidations

OLA seeks to provide a process to quickly and efficiently liquidate a large, complex financial company that is failing.¹¹⁵¹ It designates the FDIC to serve as a receiver to carry out the liquidation and wind-up of such a company when the Bankruptcy Code is found lacking.¹¹⁵² The FDIC was given broad authority to develop rules regarding its authority under OLA.

As such, the FDIC proposed the SPOE process whereby the FDIC would become the receiver of the financial institution's top-level U.S. holding company, leaving the operating subsidiaries to continue operations uninterrupted.¹¹⁵³ The FDIC would then work to ensure that the holding company can absorb the organization's losses, including those incurred by subsidiaries and thereby recapitalize the subsidiaries. The FDIC would also be able to take control of the holding company and transfer its assets to a newly created, solvent "bridge bank."¹¹⁵⁴ All of this may happen quite quickly:

[T]he FDIC has focused, in its SPOE proposal, on a 'two-step' recapitalization rather than a formal bail-in. Under the FDIC's approach, a SIFI holding company . . . is effectively 'recapitalized' over a matter of days, if not hours, by the transfer of virtually all its assets and liabilities, except for certain long-term unsecured liabilities, to a new bridge institution whose capital structure, because of the absence of those long-term unsecured liabilities, is both different and presumptively 'sound.'¹¹⁵⁵

The mechanics of OLA incorporate several bankruptcy principles. For example, it allows reorganization and liquidation,¹¹⁵⁶ debtor in possession (postpetition) or similar financing, asset sales free and clear of existing liens, and clawback of prepetition fraudulent and preferential transfers.¹¹⁵⁷ Unlike the Bankruptcy Code, however, OLA permits assumption of qualified financial contracts and overrides cross-defaults in qualified financial contracts of affiliates.

¹¹⁴⁹See Subchapter V Bill, *supra* note 1148; Chapter 14 Bill, *supra* note 1147.

¹¹⁵⁰See *id.* at 1 ("(a) In General. — Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Public Law 111-203) is repealed and any Federal law amended by such title shall, on and after the date of enactment of this Act, be effective as if title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act had not been enacted."). Notably, the chapter 14 proposal also would impose limitations on the ability of the Federal Reserve to act as lender of last resort.

¹¹⁵¹Dodd-Frank, *supra* note 1143, §§ 201 *et seq.*

¹¹⁵²Dodd-Frank, *supra* note 1143, § 203(a)(2)(F) (noting the FDIC, when it seeks to designate an institution a systemic risk to be subject to OLA, must make a written recommendation indicating why bankruptcy would not be appropriate for the financial company).

¹¹⁵³Federal Deposit Insurance Corporation, *The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013).

¹¹⁵⁴12 U.S.C. § 5390 (2010); see also Douglas G. Baird & Edward R. Morrison, *Dodd-Frank for Bankruptcy Lawyers*, 19 Am. Bankr. Inst. L. Rev. 287, 300–01 (2011) ("The FDIC's powers include the right to sell substantially all of the institution's assets to another company, 'without obtaining any approval, assignment, or consent with respect to such transfer,' unless the sale raises antitrust or related concerns. The FDIC's powers also include (implicitly) the ability to reorganize the failing institution by transferring selected assets and claims to a 'bridge financial company' that is owned, controlled, and potentially capitalized by the FDIC. The FDIC can run this bridge company for up to five years, with a view to merging it with another institution or selling a majority of its equity to private investors."); Lubben, *OLA After Single Point of Entry*, *supra* note 1145, at 1 ("The latter allows the FDIC to split the good assets from the bad, in a process that is very much like that used in '363 sales' under chapter 11").

¹¹⁵⁵Jackson Statement, *supra* note 1144, at 100–01.

¹¹⁵⁶The provision in Dodd-Frank seems to technically only authorize liquidation. See David A. Skeel, Jr. *Institutional Choice in an Economic Crisis*, 2013 Wis. L. Rev. 629, 642–43 n. 95, n. 96 (2013).

¹¹⁵⁷See Baird & Morrison, *supra* note 1154, at 1–3 ("[T]he FDIC can authorize the equivalent of DIP financing on terms virtually identical to those permitted by § 364 . . . [and] the FDIC the ability to implement rough approximations of § 363 sales and chapter 11 reorganizations").

Many commentators have criticized OLA.¹¹⁵⁸ Some suggest that it will ultimately be ineffective because it does not include resolution of foreign entities (which would be controlled by foreign regulators)¹¹⁵⁹ and most SIFIs have important components overseas.¹¹⁶⁰ (The SPOE plan and focus on the holding company could alleviate this concern depending on the corporate structure of the institution.) Others suggest that the FDIC will not be able to enforce derivative trading contracts between operating subsidiaries and their counterparties, a circumstance that was quite important in the *Lehman Brothers* bankruptcy,¹¹⁶¹ and an issue that regulators are seeking to address by imposing contractual solutions, such as the so-called “ISDA Protocol.” Still others argue that the FDIC may not be able to extend sufficient credit to maintain an institution’s liquidity because of statutory limitations on a receivership’s borrowing.¹¹⁶² Others wonder whether the FDIC will be successful as a receiver of financial institutions that are unfamiliar and not traditionally insured by the FDIC, such as hedge funds.¹¹⁶³ Perhaps most importantly, commentators worry that OLA may ultimately be a destabilizing force, rather than a stabilizing force, because it is new, flexible, and perhaps unpredictable, creating uncertainty for creditors.¹¹⁶⁴ Others have noted the balance of powers in a bankruptcy case, and that OLA concentrates power in the FDIC.¹¹⁶⁵

Proposed Subchapter V in Chapter 11

The subchapter V proposal is contained in a House bill titled “Financial Institutions Bankruptcy Act.”¹¹⁶⁶ The primary function of the proposal is to enable the Bankruptcy Code to effectuate a rapid two-step recapitalization of a SIFI holding company’s subsidiaries, similar to OLA SPOE procedure.¹¹⁶⁷ The intended result is to get the bank holding company’s assets in and out of bankruptcy quickly: the bridge holding company immediately acquires all of the SIFI holding company’s assets, including its contracts and its equity interests in recapitalized operating companies, while allowing the nonbankrupt operating subsidiaries to carry on business as usual.¹¹⁶⁸ Cross-defaults

1158For example, the FDIC will retain discretion to prefer some creditors over others of equal rank and will be able to distribute funds other than according to the bankruptcy absolute priority rule. The FDIC, rather than the market, will be making critical determinations regarding the bridge company and its equity, and the FDIC will likely attempt to run the bridge company for a while. Tom Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, at 9, App’x § 3 (Working Paper, July 9, 2014), available at <http://www.hoover.org/sites/default/files/rp-14-july-9-tom-jackson.pdf>. See also Kenneth E. Scott, *Chapter 14: Designing a Better Bankruptcy Resolution*, in *Across the Great Divide: New Perspectives on the Financial Crisis* 304, 305–06 (Martin Neil Bailly & John B. Taylor eds., 2014) (discussing the discretion allowed the FDIC to pick and choose which creditors to “bail out” and also discussing the superficial role of judges in OLA process), available at <http://www.hoover.org/sites/default/files/across-the-great-divide-ch14.pdf>.

1159Baird & Morrison, *supra* note 1154, at 31.

1160Lubben, *OLA After Single Point of Entry*, *supra* note 1145, at 1.

1161*Id.* at 2 (noting that many derivative transaction contracts provide that failure of a “credit support provider” — the holding company — allows the counterparty the right to terminate the trade); Baird & Morrison, *supra* note 1154, at 32 (discussing how OLA could in theory help alleviate the derivative trade issue but noting that the two-day window will not be enough time to evaluate all of a large institution’s derivative contracts).

1162Baird & Morrison, *supra* note 1154, at 22, 30 (“The [FDIC] must finance its activities as receiver through an ‘orderly liquidation fund,’ which is funded by borrowings from the Treasury. The FDIC’s authority to borrow from the Treasury, however, is tightly constrained. The [FDIC] cannot issue debt in connection with a receivership that exceeds specified thresholds. During the first thirty days of the receivership, loans cannot exceed ten percent of the covered financial company’s total consolidated assets, as measured by the most recent financial statements. As soon as the FDIC determines the fair market value of assets available for repayment of new debt (or after the first thirty days of the receivership, whichever occurs first), the FDIC can extend larger loans to the company, but the loans cannot exceed ninety percent of those assets’ fair market value.”) (“But the resources deemed necessary far, far exceed the modest resources that Title II make available to the FDIC”).

1163*Id.* at 31.

1164*Id.* at 33.

1165*Id.* at 2 (“traditional bankruptcy law reflects a balance of power in which the debtor in possession (DIP), the creditors’ committee, the DIP lender, and the bankruptcy judge play discrete roles; this regime concentrates power in a single entity, the FDIC.”).

1166See Subchapter V Bill, *supra* note 1148.

1167See Jackson Statement, *supra* note 1144, at 108.

1168See Stephen D. Adams, *House Advances Bipartisan Financial Institution Bankruptcy Act*, Harv. L. Sch. Bankr. Roundtable (Sept. 30, 2014), available at <http://blogs.law.harvard.edu/bankruptcyroundtable/2014/09/30/house-advances-bipartisan-financial-institution-bankruptcy-act/>; Jackson Statement, *supra* note 1144, at 104.

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in subsidiaries' qualified financial contracts would be overridden, as under OLA. The Bankruptcy Code, as currently written, would make these outcomes difficult to accomplish.¹¹⁶⁹ The proposed subchapter V in chapter 11 seeks to make chapter 11 more hospitable to an SPOE rapid two-step recapitalization process.

Overview of Recapitalization Process

Subchapter V contemplates that within the first 48 hours of a bankruptcy case, assets of a SIFI holding company would be transferred to a bridge company, and long-term unsecured debt, certain subordinated debt, and old equity would remain with the old holding company in the chapter 11 case.¹¹⁷⁰ Assuming that the bankruptcy court approves of the transfer, the old holding company's operations, including ownership of its subsidiaries, would shift to the new bridge company that is not in bankruptcy.¹¹⁷¹ Market participants are presumed to perceive the bridge company as solvent, based on new "loss absorbency" requirements being imposed on SIFIs by regulators.¹¹⁷²

After the transfer is completed, the old holding company remains a debtor in bankruptcy, but its assets may only consist of a beneficial interest in a special trust created solely to hold the equity interests in the bridge company until such interests are sold or distributed pursuant to a chapter 11 plan.¹¹⁷³ The indirect beneficiaries of this trust would likely be the holders of the long-term debt that is not transferred to the bridge company and the equity interests of the old holding company.¹¹⁷⁴ Any distributions to the chapter 11 creditors or interest-holders would depend on the value and monetization of the interests held by the special trust. For example, a distribution may occur if the bridge company is sold or otherwise merged into another company.¹¹⁷⁵

The Transfer Proceeding

Subchapter V provides that after notice and a hearing, the court may order a transfer of property of the estate to a bridge company¹¹⁷⁶ only if the court finds that the transfer:

- (a) [will] preserve or promote the financial stability in the United States, and (b) does not provide for any assumption of the long-term unsecured debt and, in addition, the Federal Reserve Board certifies that it has found that the bridge company adequately provides assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company.¹¹⁷⁷

The court may not hold a hearing on the proposed transfer sooner than 24 hours after filing so that notice may be given to the 20 largest holders of unsecured claims, the Board of Governors of the Federal Reserve System (the "**Board**"), the FDIC, the Secretary of the Treasury, and the primary

¹¹⁶⁹Jackson Statement, *supra* note 1144, at 104–05 (discussing derivative contracts and other financial contracts that are not subject to the automatic stay and cross default and change of control provisions in such financial contracts and also noting that speediness of the FDIC procedure would be difficult to achieve in bankruptcy).

¹¹⁷⁰*See id.* at 108.

¹¹⁷¹*Id.*

¹¹⁷²*See id.* at 108–09. *See also* Financial Stability Board, Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution, Nov. 2014, *available at* https://www.g20.org/sites/default/files/g20_resources/library/adequacy_loss-absorbing_capacity_global_systemically_important_banks.pdf.

¹¹⁷³*Id.* at 109.

¹¹⁷⁴*Id.*

¹¹⁷⁵*Id.*

¹¹⁷⁶*See* Subchapter V Bill, *supra* note 1148, at § 1185(a).

¹¹⁷⁷*See* Jackson Statement, *supra* note 1144, at 110–11.

financial regulator (whether domestic or foreign) with respect to any subsidiary whose ownership is proposed to be transferred to the bridge company.¹¹⁷⁸ Further, subchapter V provides for a stay on qualified contract termination rights for a period of up to 48 hours to allow the transfer to the bridge company to be substantially completed.¹¹⁷⁹ In addition, subchapter V includes provisions that are designed to permit the successful transfer of assets, contracts, liabilities, rights, licenses, and permits of both the old holding company, and of its operating subsidiaries, to the bridge company.¹¹⁸⁰

Who Would Hear Subchapter V Cases

The subchapter V proposal provides for the creation of a group of designated bankruptcy judges to hear cases arising under subchapter V of chapter 11.¹¹⁸¹ As mentioned below, the Senate's chapter 14 proposal also provides for a special arrangement of judges to hear its cases, but the two proposals offer different procedures on this point.¹¹⁸² Under subchapter V, "the Chief Justice of the United States shall designate not fewer than 10 bankruptcy judges to be available to hear a case under subchapter V. . . ."¹¹⁸³ Cases are then assigned to a specific bankruptcy judge by the chief judge of the court of appeals in the district in which the case is pending.¹¹⁸⁴ Subchapter V also provides that "the Chief Justice of the United States shall designate a particular number of judges to hear appeals under section 1183 of title 11."¹¹⁸⁵

Proposed Chapter 14

An alternative SIFI resolution scheme has been proposed in the Senate as Senate Bill 1861, the Taxpayer Protection and Responsible Resolution Act.¹¹⁸⁶ This bill proposes a new chapter of the Bankruptcy Code — chapter 14 — to address failing institutions, and it proposes to repeal OLA.¹¹⁸⁷ The chapter 14 concept finds its origins in, but differs from, the Hoover Institute's "Resolution Project," which launched in 2009 and has continued to evolve since that time.¹¹⁸⁸

Similar to the subchapter V proposal, the chapter 14 goal in effecting a rapid recapitalization of the holding or operating company is to ensure that the recapitalized institution: (i) is solvent; (ii) appears solvent to market participants; and (iii) is subject to market discipline, rather than being under the "protection" of a bankruptcy proceeding.¹¹⁸⁹ To achieve such a recapitalization,

¹¹⁷⁸See *id.* at 117; see also Subchapter V Bill, *supra* note 1148, at § 1186(b).

¹¹⁷⁹Generally speaking, the automatic stay under section 1187 terminates when the court issues an order authorizing transfer under section 1185, or after 48 hours if the court has not ordered a transfer under section 1186. See Jackson Statement, *supra* note 1144, at 110; Subchapter V Bill, *supra* note 1148, at §§ 1187, 1188.

¹¹⁸⁰See Jackson Statement, *supra* note 1144, at 111.

¹¹⁸¹Subchapter V proposes amendments to 28 U.S.C. § 298. See Subchapter V Bill, *supra* note 1148, at 32.

¹¹⁸²The judges designated to hear chapter 14 cases are all bankruptcy judges. The chapter 14 proposal calls for at least one district judge from each circuit to be available to hear appeals under the chapter. See Chapter 14 Bill, *supra* note 1147, at 28–29, § 298.

¹¹⁸³See Subchapter V Bill, *supra* note 1148, at 32.

¹¹⁸⁴*Id.*

¹¹⁸⁵*Id.*

¹¹⁸⁶Chapter 14 Bill, *supra* note 1147. Stephen D. Adams, *The Chapter 14 Proposal in the Senate*, Harv. L. Sch. Bankr. Roundtable (June 17, 2014), available at <https://blogs.law.harvard.edu/bankruptcyroundtable/2014/06/17/the-chapter-14-proposal-in-the-senate/>. See also Jackson, *Building on Bankruptcy*, *supra* note 1158, Part I.

¹¹⁸⁷See Jackson, *Building on Bankruptcy*, *supra* note 1158, at 23 (noting that while the original proposal envisioned a chapter 14, the current proposal is, in substance, similar to a new subchapter of chapter 11).

¹¹⁸⁸The Resolution Project, Hoover Institution, available at <http://www.hoover.org/research-teams/economic-policy-working-group/resolution-project> (last visited Nov. 13, 2014); Kenneth E. Scott, *A Guide to the Financial Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14*, at 1 (Stanford Law & Economics Olin Working Paper No. 426, Feb. 29, 2012) (naming the members of the project and noting that the project held several meetings, a conference, several papers, and a book), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2018035.

¹¹⁸⁹*Id.* at 19.

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the proposal contemplates a “quick sale” that would effect a sale of a holding company’s assets and liabilities (other than long-term unsecured debt, subordinated debt, and “old” equity) to a bridge company very quickly following the commencement of a bankruptcy case. This “Special Transfer,” to be codified in section 1406 of the Bankruptcy Code,¹¹⁹⁰ would remove the holding company’s assets from the bankruptcy process.

Creation of a New Chapter 14

As a starting point, the chapter 14 bill notes that such cases will generally use existing bankruptcy rules except where chapter 14 was designed to explicitly change them.¹¹⁹¹ The changes proposed for chapter 14 cases cover the creation of a new chapter 14 and provisions related to commencement of a chapter 14 case, the role of the primary regulator in the bankruptcy proceeding, the rapid transfer of the debtor to a bridge company, and qualified financial contracts treatment in chapter 14.

Who Would Hear Chapter 14 Cases

Chapter 14 calls for the Chief Justice of the United States to select at least one district judge from each circuit who will be available to hear an appeal in a chapter 14 case.¹¹⁹² Designated bankruptcy judges will hear chapter 14 cases.¹¹⁹³ In two-entity recapitalization cases, the designated bankruptcy judge must handle the case at least up to the point of the section 1406 transfer.¹¹⁹⁴

The Role of the Primary Regulator in the Bankruptcy Proceeding

In addition to its ability to file petitions (discussed above), the Board will also have standing to be heard on any issue relevant to the regulation of the debtor by the Board, or to the financial stability of the United States.¹¹⁹⁵ The FDIC is afforded more limited standing.¹¹⁹⁶ If there is a section 1406 transfer, the Board’s regulatory interest as to the debtor will shift to the bridge company,¹¹⁹⁷ although the Board will still have standing in the debtor’s case with regard to its equity ownership of the bridge company.¹¹⁹⁸

Postpetition Financing

Debtor in possession (postpetition) financing will be available in chapter 14, pursuant to the procedures and limitations set out in section 364.

¹¹⁹⁰Chapter 14 Bill, *supra* note 1147, at 14–16 (discussing proposed § 1406).

¹¹⁹¹*Id.* at 5 (“(m) Except as otherwise provided in chapter 14 of this title, chapter 11 of this title applies in a case under chapter 14 of this title.”).

¹¹⁹²*Id.* at 28 (discussing § 298(a)).

¹¹⁹³*Id.* at 28 (§ 298(b)(1), (2), and (3)).

¹¹⁹⁴*Id.* at 30 (discussing amendments to 28 U.S.C. § 1334).

¹¹⁹⁵*Id.* at 11 (discussing proposed § 1404(a)). “The Board may raise and may appear and be heard on any issue in any case or proceeding under this title relevant to the regulation of the debtor by the Board or to financial stability in the United States.” *Id.*

¹¹⁹⁶*Id.* at 11 (discussing proposed § 1404(b): “(b) The Federal Deposit Insurance Corporation may raise and may appear and be heard on any issue in any case or proceeding under this title in connection with a transfer under section 1406.”) (emphasis added).

¹¹⁹⁷Jackson, *Building on Bankruptcy*, *supra* note 1158, at 28.

¹¹⁹⁸*Id.* Chapter 14 Bill, *supra* note 1147, at 11–12 (discussing proposed § 1405).

Section 1406 Transfer

The “section 1406 transfer” is the key to implementing the two-entity recapitalization in chapter 14,¹¹⁹⁹ and is quite similar to the subchapter V proposal.¹²⁰⁰ A trustee of the debtor or the Board may immediately make a motion in a chapter 14 proceeding for a transfer of the property of the estate (including contracts) and liabilities (except for the long-term unsecured and subordinated debt and old equity — termed “capital structure debt” in chapter 14) of the debtor to a newly created bridge company.¹²⁰¹ The court must then approve the transfer.¹²⁰² The court may not hear the transfer motion sooner than 24 hours after the filing, and it must make a decision within 48 hours after the filing (as with subchapter V). The court may order the transfer only if it finds, or the Board certifies that it has found, that the bridge company adequately provides assurance of future performance of any executory contract, unexpired lease, or debt agreement being transferred to the bridge company.¹²⁰³

Making the Section 1406 Transfer Effective and Qualified Financial Contracts

The provisions of chapter 14 designed to ensure that the bridge company (in a section 1406 transfer) has the assets, rights, and liabilities of the former holding company (minus certain long-term subordinated debt and old equity) are substantially the same as the subchapter V provisions designed for those same purposes. Also similar to the subchapter V proposal, the debtor in a transfer case will essentially be a shell company, and claimants that were “left behind” must wait until the bridge company is able to make distributions under a plan.¹²⁰⁴

Moreover, to ensure that the bridge company receives all of the relevant assets and liabilities of the debtor, qualified financial contracts would be subject to the automatic stay in chapter 14 for 48 hours.¹²⁰⁵ This is a change from the current law in chapter 11, which exempts qualified financial contracts from the automatic stay altogether.

Conclusion

The House bill containing the subchapter V provisions was introduced in Congress on September 9, 2014.¹²⁰⁶ It was subsequently referred to the House Judiciary Committee, where it has since been referred and discharged by the Subcommittee on Regulatory Reform, Commercial and Antitrust Law, has been considered and marked up by the Judiciary Committee, and has been ordered to be

¹¹⁹⁹Chapter 14 Bill, *supra* note 1147, at 14–16.

¹²⁰⁰*Compare* Chapter 14 Bill, *supra* note 1147, at 14–16 (discussing proposed § 1406), *with* Subchapter V Bill, *supra* note 1148, at 12–16 (discussing proposed § 1185). The provisions share a large amount of common language, though the subchapter V bill has more specific provisions regarding executory contracts, unexpired leases, and the like).

¹²⁰¹Chapter 14 Bill, *supra* note 1147, at 14 (“(a) On request of the trustee or the Board, and after notice and hearing and not less than 24 hours after the commencement of the case, the court may order a transfer under this section of property of the estate to a bridge company.”).

¹²⁰²*Id.*

¹²⁰³*Id.* at 16.

¹²⁰⁴Jackson, *Building on Bankruptcy*, *supra* note 1158, at 37. *See* Chapter 14 Bill, *supra* note 1147, at 7, 11–12 (“The term ‘bridge company’ means a newly formed corporation *the equity securities of which are transferred to a special trustee* under section 1405(a)”) (emphasis added) (“[T]he court may order [the appointment of a] special trustee and transfer to the special trustee all of the equity securities in a corporation to hold in trust for the sole benefit of the estate. . . .”). *See also* Chapter 14 Bill, *supra* note 1147, at 7, section 1405(c) (“The special trustee shall distribute the assets held in trust in accordance with the plan on the effective date of the plan, after which time the office of the special trustee shall terminate, except as may be necessary to wind up and conclude the business and financial affairs of the trust.”).

¹²⁰⁵*See* Chapter 14 Bill, *supra* note 1147, at 22–26 (discussing treatment of qualified financial contracts in Chapter 14).

¹²⁰⁶H.R. 5421: Financial Institution Bankruptcy Act of 2014, Congress. Gov., *available at* <https://www.congress.gov/bill/113th-congress/house-bill/5421/all-actions> (last visited Nov. 17, 2014).

reported by voice vote.¹²⁰⁷ The Senate bill containing the chapter 14 proposal was introduced in the Senate on December 19, 2013. It was read twice and referred to the Senate Judiciary Committee.¹²⁰⁸

Although the Commission was aware of both bills during its deliberations, the Commission viewed issues particular to SIFIs as outside its core mission. Accordingly, the Commission stayed informed regarding the content of both bills and referenced them as appropriate or relevant during discussions. The Commission, however, did not specifically study or make recommendations on the resolution of financially distressed SIFIs or the SPOE procedure.

E. Cross-Border Cases

Geographic borders do not limit the impact of a company's financial distress. A U.S. chapter 11 debtor may have assets and creditors located in foreign jurisdictions, and a foreign debtor likewise may have assets and creditors located in the United States. Traditionally, two different approaches to these kinds of cross-border insolvency situations have been advanced: universalism (*i.e.*, a single country's laws should govern a single company's assets) and territorialism (*i.e.*, the laws of the country where the assets are located should govern those assets).¹²⁰⁹ More recently, a modified approach to universalism, encouraging cooperation and gradual adoption of unified standards, has gained increasing acceptance, most notably by the adoption of the United Nations Commission on International Trade Law (“*UNCITRAL*”) Model Law on Cross-Border Insolvency (the “*Model Law*”) in several countries.¹²¹⁰

The United States adopted a version of the Model Law in 2005 with the enactment of chapter 15 of the Bankruptcy Code.¹²¹¹ Chapter 15 replaced section 304 of the Bankruptcy Code, and expanded

¹²⁰⁷*Id.* See also Stephen D. Adams, *House Advances Bipartisan Financial Institution Bankruptcy Act*, Harv. L. Sch. Bankr. Roundtable (Sept. 30, 2014), available at <http://blogs.law.harvard.edu/bankruptcyroundtable/2014/09/30/house-advances-bipartisan-financial-institution-bankruptcy-act/>.

¹²⁰⁸S. 1861: Taxpayer Protection and Responsible Resolution Act, Congress. Gov., available at <https://www.congress.gov/bill/113th-congress/senate-bill/1861/all-actions> (last visited Nov. 17, 2014).

¹²⁰⁹See, e.g., Jay Lawrence Westbrook, *Chapter 15 at Last*, 79 Am. Bankr. L.J. 713, 715 (2005) (“In general, universalism would treat a multinational bankruptcy ideally as a unified global proceeding administered by a single court assisted by courts in other countries, while territorialism is the traditional approach by which each court in a country in which assets are found seizes them (the ‘grab rule’) and uses them to pay local creditors.”). See also Edward S. Adams & Jason Fincke, *Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism*, 15 Colum. J. Eur. L. 43 (2008) (discussing two approaches); Lynn M. LoPucki, *Cooperation in International Bankruptcy: A Post-Universalist Approach*, 84 Cornell L. Rev. 696 (1999) (analyzing approaches); Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Laws and Choice of Forum*, 65 Am. Bankr. L.J. 457 (1991) (explaining universalism).

¹²¹⁰Donald S. Bernstein, et al., *Recognition and Comity in Cross-Border Insolvency Proceedings*, in *The International Insolvency Review*, at 3, (Donald S. Bernstein ed., 2013) (“[T]here is no question that the universalist approach has been in the ascendancy, culminating in the adoption in not fewer than 19–20, counting the British Virgin Islands — countries of laws based on the UNCITRAL Model Law on Cross-Border Insolvency (the Model Law).”), available at http://www.davispolk.com/sites/default/files/52350054_1.PDF.

¹²¹¹Section 1501 explains:

(a) The purpose of this chapter is to incorporate the Model Law on Cross-Border Insolvency so as to provide effective mechanisms for dealing with cases of cross-border insolvency with the objectives of —

(1) cooperation between —

(A) courts of the United States, United States trustees, trustees, examiners, debtors, and debtors in possession; and

(B) the courts and other competent authorities of foreign countries involved in cross-border insolvency cases;

(2) greater legal certainty for trade and investment;

the ability of courts to recognize foreign insolvency proceedings. “Echoing the Model Law, the stated purpose of Chapter 15 is to promote ‘cooperation’ between courts and to provide ‘greater legal certainty’ in multi-jurisdictional cases.”¹²¹²

Under chapter 15, a foreign representative¹²¹³ may seek recognition of the foreign insolvency proceeding by filing certain evidence of such proceeding with its chapter 15 petition.¹²¹⁴ Section 1516 of the Bankruptcy Code creates a presumption (i) in favor of the evidence filed by the foreign representative; and (ii) that the location of the foreign debtor’s registered office is its center of main interests (commonly referred to as “COMI”).¹²¹⁵ The chapter 15 recognition process is more simple and straightforward than under prior law.¹²¹⁶

The consequences of the court’s recognition of a foreign proceeding under chapter 15 turn largely on the classification of the foreign proceeding as either main or non-main. Section 1517 provides that the foreign proceeding is a “main” proceeding if it is pending in the country of the debtor’s COMI.¹²¹⁷ Otherwise, the foreign proceeding is considered a “non-main” proceeding.¹²¹⁸ In a main proceeding, among other things, the automatic stay of section 362 of the Bankruptcy Code applies, and the foreign representative may operate the debtor’s business and sell, lease, or use the debtor’s assets under section 363.¹²¹⁹ In addition, the court may order certain additional relief in a main or non-main proceeding “where necessary to effectuate the purpose of this chapter and to protect the assets of the debtor or the interests of the creditors.”¹²²⁰ Absent such an order by the court, however, no other relief generally is available in a non-main proceeding.

(3) fair and efficient administration of cross-border insolvencies that protects the interests of all creditors, and other interested entities, including the debtor;

(4) protection and maximization of the value of the debtor’s assets; and

(5) facilitation of the rescue of financially troubled businesses, thereby protecting investment and preserving employment.

11 U.S.C. § 1501. For articles generally discussing the adoption and implementation of chapter 15, see Jay Lawrence Westbrook, *Chapter 15 and Discharge*, 13 Am. Bankr. Inst. L. Rev. 503 (2005); Samuel L. Bufford, *International Accord: Included in the New Bankruptcy Law Are Provisions Adopting the U.N. Model on International Insolvencies*, L. A. Law., July/Aug. 2006, at 32; John J. Chung, *Chapter 15 of the Bankruptcy Code and Its Implicit Assumptions Regarding the Foreign Exchange Market*, 76 Tenn. L. Rev. 67 (2008).

1212 See Bernstein, et al., *supra* note 1210, at 5.

1213 Section 101(24) of the Bankruptcy Code defines “foreign representative” as “a person or body, including a person or body appointed on an interim basis, authorized in a foreign proceeding to administer the reorganization or the liquidation of the debtor’s assets or affairs or to act as a representative of such foreign proceeding.” 11 U.S.C. § 101(24).

1214 Section 1515 provides in pertinent part:

(b) A petition for recognition shall be accompanied by —

(1) a certified copy of the decision commencing such foreign proceeding and appointing the foreign representative;

(2) a certificate from the foreign court affirming the existence of such foreign proceeding and of the appointment of the foreign representative; or

(3) in the absence of evidence referred to in paragraphs (1) and (2), any other evidence acceptable to the court of the existence of such foreign proceeding and of the appointment of the foreign representative.

11 U.S.C. § 1515(b).

1215 11 U.S.C. § 1516.

1216 See Westbrook, *Chapter 15 at Last*, *supra* note 1209, at 721–23.

1217 Section 1502(4) defines “**foreign main proceeding**” as “a foreign proceeding pending in the country where the debtor has the center of its main interests.” 11 U.S.C. §§ 1502(4), 1517(b)(1).

1218 Section 1502(5) defines “foreign non-main proceeding” as “a foreign proceeding, other than a foreign main proceeding, pending in a country where the debtor has an establishment.” 11 U.S.C. §§ 1502(5), 1517(b)(2).

1219 11 U.S.C. § 1520.

1220 11 U.S.C. § 1521(a).

Chapter 15 and the Model Law are premised on notions of increased cooperation and respect for foreign proceedings in cross-border cases. Nevertheless, some courts limit their deference to comity in cases involving transfers of assets within the territorial jurisdiction of the United States. For example, the court in *Elpida Memory* noted the absence of any reference to comity in section 1520 of the Bankruptcy Code, and required the foreign representative to meet the standards of section 363 of the Bankruptcy Code to sell or assign the U.S. assets at issue.¹²²¹ Other courts, however, suggest a more prominent role for comity in chapter 15 cases.¹²²²

Section 1507(b) expressly incorporates considerations of comity into chapter 15 proceedings, providing:

In determining whether to provide additional assistance under this title or under other laws of the United States, the court shall consider whether such additional assistance, consistent with the principles of comity, will reasonably assure —

- (1) just treatment of all holders of claims against or interests in the debtor's property;
- (2) protection of claim holders in the United States against prejudice and inconvenience in the processing of claims in such foreign proceeding;
- (3) prevention of preferential or fraudulent dispositions of property of the debtor;
- (4) distribution of proceeds of the debtor's property substantially in accordance with the order prescribed by this title; and
- (5) if appropriate, the provision of an opportunity for a fresh start for the individual that such foreign proceeding concerns.¹²²³

This section suggests that courts should undertake a balancing of the interests at hand, specifically considering the rights and expectations of the various parties in the different jurisdictions, based on the law of those jurisdictions. Section 1521(b) also incorporates a similar balancing test when the foreign representative requests authority over the debtor's U.S. assets. That section provides that

¹²²¹ *In re Elpida Memory Inc.*, 2012 WL 6090194, at *7 (Bankr. D. Del. Nov. 20, 2012):

Section 1520(a)(2) provides that section 363 of the Bankruptcy Code applies “to a transfer of an interest of the debtor in property that is within the territorial jurisdiction of the United States to the same extent that the section would apply to property of the estate.” Section 363(b)(1), in turn, provides that the “trustee, after notice and a hearing, may use, sell, or lease, other than in the ordinary course of business, property of the estate.” Under section 1520(a)(3), “the foreign representative may operate the debtor's business and may exercise the rights and powers of a trustee under and to the extent provided by section [] 363.” . . . The section 363(b) standard is well-settled. A debtor may sell assets outside the ordinary course of business when it has demonstrated that the sale of such assets represents the sound exercise of business judgment. In determining whether a sale satisfies this standard, the courts in this Circuit require that a sale satisfy four requirements: (1) a sound business purpose exists for the sale; (2) the sale price is fair; (3) the debtor has provided adequate and reasonable notice; and (4) the purchaser has acted in good faith.

Id. at *4. For different approaches to comity between the bankruptcy court and the court of appeals, see *In re Fairfield Sentry Ltd.*, 484 B.R. 615, 627 (Bankr. S.D.N.Y. 2013) (“[i]n fashioning relief [under chapter 15], courts must ‘take into account the interests of the United States, the interests of the foreign state or states involved, and the mutual interests of the family of nations in just and efficiently functioning rules of international law.’”) (quoting *In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1053 (5th Cir. 2012)), *vac'd*, 768 F.3d 239 (2d Cir. 2014) (noting that the bankruptcy court was required to apply section 363 of the Bankruptcy Code (made applicable by 11 U.S.C. § 1520(a)(2)) when the property to be transferred is within the territorial jurisdiction of the United States).

¹²²² See, e.g., *In re Vitro S.A.B. de CV*, 701 F.3d 1031, 1053 (5th Cir. 2012).

¹²²³ 11 U.S.C. § 1507(b). Section 1509(c) also discusses comity, providing that “[a] request for comity or cooperation by a foreign representative in a court in the United States other than the court which granted recognition shall be accompanied by a certified copy of an order granting recognition under section 1517.” 11 U.S.C. § 1509(c).

“the court may, at the request of the foreign representative, entrust the distribution of all or part of the debtor’s assets located in the United States to the foreign representative or another person, including an examiner, authorized by the court, provided that the court is satisfied that the interests of creditors in the United States are sufficiently protected.”¹²²⁴

The *Jaffe v. Samsung Electronics Co.* case is one example of the tension that can arise when courts consider the competing interests of parties in the respective countries.¹²²⁵ In *Jaffe*, the foreign representative sought discretionary relief under section 1521(b), including the right to control and dispose of U.S. licenses. The foreign representative then terminated the U.S. licenses, and the licensees asserted their rights to continue to use the underlying intellectual property pursuant to section 365(n) of the Bankruptcy Code.¹²²⁶ After several hearings, the Fourth Circuit ultimately affirmed the bankruptcy court’s decision that, under section 1521(b), the licensees’ interests would only be reasonably protected if the court enforced section 365(n) against the foreign representative.¹²²⁷ In reaching this decision, the Fourth Circuit did not discuss the bankruptcy court’s use of section 1506, which states that “[n]othing in this chapter prevents the court from refusing to take an action governed by this chapter if the action would be manifestly contrary to the public policy of the United States.”¹²²⁸ The treatment of intellectual property licenses in a chapter 15 case is just one of the several issues that may implicate issues of comity because the Bankruptcy Code often provides greater powers for the trustee, or more protections for nondebtor parties (as in the case of intellectual property licenses), than may be available in the foreign jurisdiction.¹²²⁹

The Commission did not find chapter 15 issues specifically within its mission, but it recognized the important interplay between chapter 11 and chapter 15 for multinational debtors. The Commission discussed the importance of comity at several points during their deliberations, frequently considered the implications of their recommendations in the international insolvency context, and reviewed the approaches of different countries to many of the issues they ultimately addressed in the recommended principles. Notably, the Commission recommended including foreign patents, copyrights, and trademarks (subject to the limitations recommended for domestic trademarks in the related principles) in the definition of “intellectual property” under the Bankruptcy Code, which would extend section 365(n) protections to licensees under foreign intellectual property licenses.¹²³⁰ Additionally, in approving a principle to allow the trustee to pursue foreign subsequent transferees under section 550 of the Bankruptcy Code, the Commission voted to specifically limit this remedy by notions of comity.¹²³¹ Moreover, the Commission is aware that Congress has considered legislation that would have addressed the issue presented by the *Jaffe* case¹²³² and that the Rules

¹²²⁴11 U.S.C. § 1521(b).

¹²²⁵See, e.g., *Jaffe v. Samsung Electronics Co. Ltd. (In re Qimonda)*, 737 F.3d 14 (4th Cir. 2013).

¹²²⁶For background on the issues in the case, see generally *In re Qimonda AG*, 462 B.R. 165, 167 — 70, 173 — 77 (Bankr. E.D. Va. 2011).

¹²²⁷See *Jaffe*, 737 F.3d at 31–32 (“We conclude that the bankruptcy court’s findings in this regard are not unreasonable and that the bankruptcy court was justified in its skepticism of Jaffe’s claim that the Licensees’ interests would now be ‘sufficiently protected’ by his commitment not to charge them an exorbitant rate during their re-licensing negotiations.”).

¹²²⁸11 U.S.C. § 1506. See also *Qimonda*, 462 B.R. at 185 (finding that, under section 1506, “deferring to German law, to the extent it allows cancellation of the U.S. patent licenses, would be manifestly contrary to U.S. public policy”).

¹²²⁹For a general discussion of the intersection of section 365(n) and chapter 15, see Peter M. Gilhuly, et al., *Intellectually Bankrupt? The Comprehensive Guide to Navigating IP Issues in Chapter 11*, 21 Am. Bankr. Inst. L. Rev. 1, 43–45 (2013).

¹²³⁰See Section V.A.4, *Intellectual Property Licenses*.

¹²³¹See Section V.C.2, *Recoveries Under Section 550*.

¹²³²See Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013), available at <https://www.congress.gov/113/bills/hr3309/BILLS-113hr3309rfs.pdf>.

(d) Protection of Intellectual-Property Licenses in Bankruptcy. –

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Committee has proposed amendments to the Bankruptcy Rules that, if approved, would make the following three changes to rules relating to chapter 15: “(i) remove the chapter 15-related provisions from Bankruptcy Rules 1010 and 1011; (ii) create a new Bankruptcy Rule 1012 to govern responses to a chapter 15 petition; and (iii) augment Bankruptcy Rule 2002 to clarify the procedures for giving notice in cross-border proceedings.”¹²³³ Accordingly, the Commission includes this summary of cross-border cases under chapter 15 to highlight issues that may indirectly relate to the chapter 11 principles proposed in the Report.

(1) In General. — Section 1522 of title 11, United States Code, is amended by adding at the end of the following:

“(e) Section 365(n) shall apply to cases under this chapter. If the foreign representative rejects or repudiates a contract under which the debtor is a licensor of intellectual property, the licensee under such contract shall be entitled to make the election and exercise the rights described in section 365(n).”

¹²³³See Preliminary Draft of Proposed Amendments to the Federal Rules of Appellate, Bankruptcy, Civil, and Criminal Procedure, at 82, Aug. 2014, available at <http://www.uscourts.gov/uscourts/rules/preliminary-draft-proposed-amendments.pdf>.



X. CONCLUSION

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The Commission's process revealed a growing consensus for the reform of chapter 11. Although not every witness who testified or professional who worked on the project agreed with this broad statement or on the particular aspects in need of reform, most identified general areas of chapter 11 practice that no longer work as effectively as possible. Moreover, the field hearings and the Commission's research found that these deficiencies in chapter 11 are having an adverse impact on distressed companies and their stakeholders, particularly with respect to small and medium-sized enterprises.

Overall, the Commission concluded that the Recommended Principles, when taken in concert, would significantly improve chapter 11 and make it a more viable and effective restructuring option for distressed companies of all sizes, including small and medium-sized enterprises. The Commission believed that its process was thorough, inclusive, transparent, and robust. This Report sets forth as fully as possible the issues; the different perspectives on those issues; the relevant research (including witness testimony, academic literature, empirical studies, and case law); and the Commission's deliberations, findings, and recommendations. The Commission hopes that the Report not only further informs the dialogue surrounding chapter 11 reform and leads to spirited debate on the issues, but also that it leads to serious consideration and adoption by policymakers of many, if not all, of the Recommended Principles in the Report.

APPENDIX A: MEMBERS OF THE ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11

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D.J. (Jan) Baker

Latham & Watkins LLP

New York, NY



Jan Baker is a partner in the New York office of Latham & Watkins and Global Co-Chair of the firm's insolvency practice. Mr. Baker represents companies, lenders, committees, acquirors and other parties in connection with restructuring matters. He also regularly advises boards of directors of public and private companies on matters related to corporate governance and fiduciary duty.

During his career, Mr. Baker has had primary responsibility in numerous restructuring matters. Some of the companies that he has represented in either out-of-court restructurings or Chapter 11 cases include: American Pad & Paper Company, Archstone, Boston Generating, CIRCLE K Company, The Delaco Company, Diamond M, DRECO Energy Services, FiberMark, Inc., FoxMeyer

Drug Company, GenTek, Inc., Global Marine Inc., Graham-Field Health Products, Inc., Kaneb, Inc., MCorp., MicroAge, Inc., Owens Corning, RCN Corporation, Safety Kleen Systems, Inc., Spectrum Brands, Sterling Chemicals, Inc., The Stroh Brewery Company and Winn-Dixie Stores, Inc.

Mr. Baker is a Fellow, the immediate past chair and a former president of the American College of Bankruptcy. He frequently lectures and writes on issues involving corporate reorganization and restructuring. Mr. Baker was selected by *The Best Lawyers in America* 2012 as a recommended attorney for Bankruptcy Litigation. He was recently named one of the "Most Admired Attorneys" by *Bankruptcy Law360* and was recognized by *The International Who's Who* as "most highly regarded" in the Insolvency & Restructuring Lawyers 2011 category. Mr. Baker has also been named among the top attorneys in the US in the 2010 *Lawdragon 500 Leading Lawyers in America* guide and is recognized as a leading corporate restructuring attorney by legal guides and directories such as *Chambers Global*, *Chambers USA*, *Euromoney*, *Legal Media Group*, *Turnarounds and Workouts* and *K&A Restructuring Register*. The most recent *Chambers Global 2010* directory refers to Mr. Baker as the "ultimate bankruptcy lawyer – the one you want on your team at all times."

Donald S. Bernstein

Davis Polk & Wardwell LLP

New York, NY



Donald S. Bernstein is a partner with the international law firm Davis Polk & Wardwell LLP based in New York, where he is Practice Group Coordinator and co-Head of the firm's Insolvency and Restructuring Practice Group. Mr. Bernstein's practice includes representing debtors, creditors, liquidators, receivers and acquirers in major corporate restructurings and insolvency proceedings, as well as advising financial institutions regarding resolution planning and the credit risks involved in derivatives, securities transactions, and other domestic and international financial transactions. He is a past chair of the National Bankruptcy Conference, a Commissioner on the ABI Commission to Study the Reform of Chapter 11, a director and member of the Executive Committee of the International Insolvency Institute and a past director of the

American College of Bankruptcy. He has been Treasurer and a member of the Executive Committee of The Association of the Bar of the City of New York, and is a former Chair of the New York City Bar Association's Committee on Bankruptcy and Corporate Reorganization and of the TriBar Opinion Committee. He is also on the Board of Editors of *Collier on Bankruptcy* and is Editor-in-Chief of the *International Insolvency Review*. Mr. Bernstein served as a member of the Official United States Delegation to the United Nations Commission on International Trade Law and participated in the development of UNCITRAL's Model Law on Cross Border Insolvency. He also has been a member of the Legal Advisory Panel of the Financial Stability Board. Mr. Bernstein is invited frequently to lecture and teach on insolvency law and bank regulatory and resolution issues, including in recent years at Princeton, Harvard, The University of Chicago, Columbia, The University of Pennsylvania, New York University and St. John's University. Mr. Bernstein graduated from Princeton University and received his J.D. from the University of Chicago Law School.

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William (Bill) A. Brandt, Jr.

Development Specialists, Inc.

Chicago, IL



Bill Brandt has been in the business of workout, turnaround and insolvency consulting for more than thirty years and is widely recognized as one of the foremost practitioners in the field. He is President and CEO of Development Specialists, Inc. (“DSI”), a firm specializing in the provision of management, consulting and turnaround assistance to troubled or reorganizing enterprises. Mr. Brandt and his firm continue to be involved with some of the more celebrated financial restructuring cases in the nation’s history, including Mercury Finance Company, Southeast Banking Corporation, Malden Mills, the Keck, Mahin & Cate law firm, the Coudert Brothers law firm, the Ohio “Coin Fund” scandal, and the Bernie Ebbers Settlement Trust. The firm maintains offices in Chicago, New York, Philadelphia, Los Angeles, London, Miami, San Francisco, Cleveland, and Columbus.

Mr. Brandt has advised Congress on matters of insolvency and bankruptcy policy, and in that capacity was the principal author of the amendment to the Bankruptcy Code permitting the election of Trustees in Chapter 11 cases. He was also involved in drafting several amendments to the Bankruptcy Code enacted into law in April 2005 as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which substantially rewrote the nation’s bankruptcy laws. During the Clinton administration, he served as a member of the President’s National Finance Board as well as serving as a delegate from the State of Florida to the 1996 Democratic National Convention. During that decade as well, and upon the invitation of both business and political leaders in the People’s Republic of China, Mr. Brandt worked with various public policy, law and banking leaders in that country on approaches to the reorganization and restructuring of some of China’s state-owned industries. In 2000, he served as a member of the Democratic Party’s National Convention Platform Committee. In 2002, he served on the Illinois Gubernatorial Transition Team as well as on the State of California’s Business Delegation dispatched to Cuba to discuss politics, business and trade. In 2008, Mr. Brandt served as a delegate from the State of Illinois to the Democratic National Convention.

By Gubernatorial appointment, Mr. Brandt is serving his second consecutive term as Chair of the Illinois Finance Authority, having been first appointed in 2007 and then reappointed in 2010. The IFA is one of the nation’s largest self-financed entities principally engaged in issuing taxable and tax-exempt bonds, making loans, and investing capital for businesses, non-profit organizations and local government. The Governor has also appointed Mr. Brandt to the Illinois Broadband Deployment Council, which works to ensure that advanced telecommunications services are available to all the citizens of Illinois. He serves as a member of the National Advisory Council for the Institute of

Governmental Studies at the University of California at Berkeley, while also serving as a member of the Board of Trustees of Loyola University Chicago, and is a life trustee of Fenwick High School in Oak Park, Illinois. Additionally, he was also featured in *What Happened*, a documentary film humorously chronicling the dot-com “bust,” which premiered at the New York City Film Festival.

Mr. Brandt has written for publications that span a broad spectrum of thought, ranging from *Maclean's*, Canada's Weekly Newsmagazine, to *Directors & Boards*, *Corporate Board Magazine*, the *Florida Real Estate Journal*, and the *American Bankruptcy Institute Law Review*, published in conjunction with St. John's University School of Law. He is the co-author of the “Due Diligence” chapter in the 2nd edition of *Bankruptcy Business Acquisitions*, published by the American Bankruptcy Institute. He is a frequent lecturer and speaker on topics of corporate restructuring, bankruptcy and related public policy issues and regularly appears on CNN, CNBC, CNNfn, Bloomberg, and Canada's BNN, as well as the CBS Radio and National Public Radio networks. He has been profiled and interviewed in a wide array of periodicals including, among others, *The Wall Street Journal*, *The New York Times*, *The International Herald Tribune*, *Business Week*, *The Miami Herald*, *The Chicago Tribune*, *The Boston Globe*, *Billboard Magazine* and *Bank Bailout Litigation News*.

He served several terms as a member of the Board of Directors of the American Bankruptcy Institute, as well as also serving several terms on the Advisory Board for that organization's Law Review. He served for almost 20 years as a member of the private Panel of Trustees for the United States Bankruptcy Court for the Northern District of Illinois and briefly served as a member of the same panel for the Bankruptcy Court in the Southern District of Florida in the late 1980s. He is a member of the Executive Committee of the Bankruptcy Section of the Commercial Law League of America and serves on their National Government Affairs Committee. Mr. Brandt is a member of the Board of Advisors for the American Bankruptcy Institute's Bankruptcy Battleground West seminar held annually in Los Angeles and is also currently serving his third consecutive three-year term as a member of the Board of Directors of the San Francisco Bay Area Bankruptcy Forum. In addition to the Commercial Law League of America and the American Bankruptcy Institute, he holds memberships in the National Association of Bankruptcy Trustees, the International Council of Shopping Centers and the Urban Land Institute.

His biography appears in a number of reference works including *Who's Who in America*, *Who's Who in Finance and Industry*, and *Who's Who in American Law*. For well more than a dozen years, his firm, Development Specialists, Inc., has been rated as one of the outstanding turnaround firms in the world by the publication *Turnarounds & Workouts*. Mr. Brandt has also been routinely listed in the *K & A Restructuring Register*, an annual roster of the country's top 100 restructuring advisors. He received his B.A. from St. Louis University and his M.A. from the University of Chicago, where he also completed further post-graduate work toward a doctoral degree.

2022 ANNUAL SPRING MEETING

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Jack Butler

Hilco Global

Northbrook, IL



Jack Butler works with healthy and distressed companies, their boards, management, owners, creditors and investors on a broad range of asset valuation, monetization and strategic solutions and transactions for which Hilco Global acts as advisor, agent, co-investor and/or as a principal.

One of the most well-known and highly regarded dealmakers and thought leaders in the restructuring, corporate reorganization and M&A community, prior to joining Hilco Global, Jack was a founder and leader of the corporate restructuring practice at Skadden, Arps, Slate, Meagher & Flom LLP. Jack has advised on restructuring solutions for such companies as Delphi Corporation, Kmart Corporation and Xerox Corporation and on behalf of creditors including most recently in American Airlines' reorganization and merger with US Airways Group, Inc. The American-US Airways transaction was cited for its innovation, collaboration and creativity by the Financial Times, which separately profiled Jack for developing "creative solutions" during the credit crisis.

Jack is a member of the M&A Advisors' Hall of Fame and the Turnaround, Restructuring and Distressed Investing Industry Hall of Fame. He is also a recipient of the Ellis Island Medal of Honor, which is given to Americans who exemplify outstanding qualities in both their personal and professional lives. A founder and past chairman of the Turnaround Management Association, Jack has served in leadership positions for many other industry organizations, including the American Bankruptcy Institute, American Board of Certification, the Commercial Finance Association and its Education Foundation, INSOL International, and the New York Institute of Credit. He is also a fellow in the American College of Bankruptcy and International Insolvency Institute. In addition to serving in leadership positions with numerous civic and charitable organizations, Jack officiated high school and college football for many years and is a lifetime member of the American Football Coaches Association.

Babette A. Ceccotti

Cohen, Weiss and Simon LLP

New York, NY



Babette A. Ceccotti joined the firm in 1983, and became a partner in 1990.

Ms. Ceccotti focuses on the firm's bankruptcy and employee benefits practice areas. As part of her bankruptcy work, she represents unions and employee benefit plans in employer bankruptcy proceedings. President Clinton appointed her to the nine-member National Bankruptcy Review Commission from 1995-1997.

Ms. Ceccotti's employee benefits practice includes litigation and counseling regarding regulatory compliance, plan administration governance and other matters.

Ms. Ceccotti is the author of several articles on labor and employee benefit issues in bankruptcy, including publications in the *American Bankruptcy Institute Law Review*, in *Business Law Today* and in the newsletter of the American Bar Association Section of Labor and Employment Law. She is co-author of a chapter on protecting union interests in employer bankruptcy in *Labor Law and Business Change*. She has also been a contributing editor of the *Employee and Union Member Guide to Labor Law*, published by the National Lawyers Guild, and a contributing author of supplements to the *ABA/BNA Employee Benefits Law* treatise.

Ms. Ceccotti graduated *cum laude* from Clark University in 1977, and from the New York Law School in 1983.

2022 ANNUAL SPRING MEETING

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Hon. Arthur J. Gonzalez (retired)

U.S. Bankruptcy Court, Southern District of New York; NYU School of Law

New York, NY



Judge Gonzalez was born in Brooklyn, New York in 1947. Judge Gonzalez received an undergraduate degree in accounting from Fordham University in 1969 and a master's degree in education from Brooklyn College in 1974. He received a J.D. from Fordham University School of Law in 1982 and received an LL.M. in taxation from New York University School of Law in 1990. Judge Gonzalez was an attorney in the Office of Chief Counsel of the Internal Revenue Service earning the Chief Counsel's Special Achievement Award for three consecutive years. Thereafter, he practiced with the firms of Pollner, Mezan, Stolzberg, Berger & Glass, P.C. and Gaston & Snow in New York City. Judge Gonzalez was appointed Assistant United States Trustee in the Southern District of New York in 1991 and United States Trustee for Region 2 (Second Circuit) in

1993, serving in that position until his appointment to the United States Bankruptcy Court for the Southern District of New York in 1995 for a fourteen-year term. At the completion of his first term in 2009, he was reappointed to another term. In early 2010, Judge Gonzalez became Chief Judge of the Bankruptcy Court for the Southern District of New York. On March 1, 2012, Judge Gonzalez retired as a Bankruptcy Judge and became a full-time professor of law as a Senior Fellow at New York University School of Law.

Steven M. Hedberg

Perkins Coie LLP

Portland, OR



Steve Hedberg is the Chief Operating Officer of Perkins Coie LLP. As the firm's most senior business professional, Steve is responsible for all aspects of the firm's operations and strategic growth. Steve was previously a partner at Perkins Coie with an active insolvency practice for more than two decades and sat on the firmwide Management and Executive Committees. Steve also served as the firm's National Co-Chair of its Insolvency Practice.

An elected Fellow in the American College of Bankruptcy, Steve's practice achievements include creditor representation in some of the nation's largest bankruptcy cases, such as Enron, Pacific Gas & Electric, Delta Airlines, Northwest Airlines, and American Airlines as well as counsel to debtors, Creditors' Committee and other constituencies in bankruptcy cases, receiverships, compositions of creditors and assignments for the benefit of creditors. He is listed in *The Best Lawyers in America* and *Oregon Law and Politics*, which named him a "Top 50 Super Lawyer" in Oregon and was certified in Business Bankruptcy Law and Creditors' Rights law by the American Board of Certification for over 20 years.

Steve obtained his business degree from Portland State University and earned his J.D. from the Northwestern School of Law of Lewis and Clark College. He has served in leadership roles in several community organizations, including as a board member of the United Way of the Columbia-Willamette and the Oregon Trail Chapter of the American Red Cross. Additionally, Steve maintains a long-standing affiliation with the Portland Center Stage, a regional theater company in which he served as Treasurer, Secretary and Chair of its board of directors.

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Robert J. Keach (Co-chair)

Bernstein, Shur, Sawyer & Nelson

Portland, ME



Robert J. Keach is a shareholder at Bernstein, Shur, Sawyer & Nelson, Portland, Maine. Mr. Keach is a Fellow of the American College of Bankruptcy and a Past President (2009-2010) of the American Bankruptcy Institute (“ABI”). Mr. Keach is also the Co-chair of the ABI’s Commission to Study the Reform of Chapter 11. Mr. Keach focuses on the representation of various parties in workouts and bankruptcy cases, including debtors, creditors, creditors committees, lessors and third parties acquiring troubled companies and/or their assets. Mr. Keach has appeared as a panelist on national bankruptcy, lender liability and creditors rights programs, and is the author of several articles on bankruptcy and creditors’ rights appearing in the *ABI Law Review*, *Commercial Law Journal* and *ABI Journal*, among other publications. Mr. Keach is a contributing

author to *Collier Guide to Chapter 11: Key Topics and Selected Industries* (2011 Ed.). Mr. Keach is recognized as a “Star Individual” in Corporate M&A/Bankruptcy in *Chambers USA*, in *Best Lawyers in America* (Ten-Year Certificate), and by *New England Super Lawyers* (Bankruptcy and Top 100 Lawyers in New England regardless of specialty). Mr. Keach is also certified in business bankruptcy by the American Board of Certification. Most recently, Mr. Keach has, *inter alia*, represented ad hoc committees in the *Homebanc Mortgage*, *New Century TRS Holdings*, and *Nortel Networks* cases in Delaware, as well as a public utilities commission in the *FairPoint Communications* case in the Southern District of New York. Mr. Keach was the fee examiner in *In re AMR Corporation* (the chapter 11 cases of American Airlines and its parent and certain affiliates). Mr. Keach is currently the chapter 11 trustee in the railroad reorganization case of *Montreal Maine & Atlantic Railway, Ltd.*, as well as the fee examiner in *Exide Technologies*.

Prof. Kenneth N. Klee

University of California at Los Angeles, School of Law; Klee, Tuchin, Bogdanoff & Stern LLP

Los Angeles, CA



Prof. Kenneth N. Klee joined the UCLA Law faculty in July 1997 after teaching bankruptcy and reorganization law as a Visiting Lecturer. He taught at Harvard Law School during the 1995–1996 academic year as the Robert Braucher Visiting Professor from Practice and at Georgia State University College of Law during 2003 as the SBLI Visiting Professor.

From 1974 to 1977, Professor Klee was associate counsel to the Committee on the Judiciary, U.S. House of Representatives, where he was one of the principal draftsmen of the 1978 Bankruptcy Code. He served as a consultant on bankruptcy legislation to the U.S. Department of Justice in 1983 and 1984. Professor Klee served as a member of the Standing Committee on Discipline for the United States District Court for the Central District of California from 2001–2005. He served as a lawyer delegate to the Ninth Circuit Judicial Conference from 1988 to 1991 and 2000 to 2003. From 1992 to 2000 he served as a member of the Advisory Committee on Bankruptcy rules to the Judicial Conference of the United States. He also served as an adviser to the American Law Institute's Transnational Insolvency Project.

Professor Klee is a founding Member of Klee, Tuchin, Bogdanoff & Stern LLP, specializing in corporate reorganization, insolvency, and bankruptcy law. Representative clients of Mr. Klee have included: Equity investors in 203 N. La Salle Street Assocs.; Boston Chicken Plan Trust as majority equity owner of Einstein/Noah Bagel Corp.; First Trust and Bank of New York, trustees, as appellees before the New York Court of Appeals and the United States Court of Appeals for the Eleventh Circuit in *Chemical Bank v. First Trust (In re Southeast Banking Corp.)*; Maxwell Communication Corp. PLC, as appellant before the United States Court of Appeals for the Second Circuit in *Maxwell Communication Corp. PLC v. Societe Generale, et al.*; the out-of-court Bondholders' Steering Committee in *Primestar*; *400 South Hope Street Associates L.P.*, in which he served as lead debtor's counsel; the debtors in *Barney's Inc., et al.*, as debtors' special counsel; the debtors in *Anacomp, Inc.*; the debtors in *Sun World*; the debtors in the five administratively consolidated *Standard Brands Paint Company* cases; the debtor in *Financial Corporation of America*; the creditors' committees in the *Adelphia*, *Del Taco*, *Iridium*, *Papercraft* and *Griffin Resorts, Inc.* chapter 11 cases; the noteholders' committee in *PG&E National Energy Group*, the out-of-court bondholders' committees in the Charter Medical and Orion Pictures restructurings; and Pennzoil, in the *Texaco Inc.* chapter 11 case. He also has served as an expert witness in over 50 matters and also renders services as an arbitrator or mediator.

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Professor Klee has served as member of the executive committee of the National Bankruptcy Conference from 1985 to 1988, 1992 to 2000, and 2004 - 2007. He served as Chair of the National Bankruptcy Conference's legislation committee from 1992 to 2000. Professor Klee is past president of the Financial Lawyers Conference and serves on its board of governors. He has also served as chairman of the Subcommittee of New and Pending Legislation of the Business Bankruptcy Committee of the Section on Corporations, Business and Banking Law of the American Bar Association. He is a frequent lecturer and panelist on programs for bankruptcy lawyers sponsored by the American Law Institute/American Bar Association.

Professor Klee is the author of: *Bankruptcy and the Supreme Court* (Lexis-Nexis 2008) (Supreme Court bankruptcy case data base available at <http://www.law.ucla.edu/home/apps/supremecourtcases/>); and co-author of *Business Reorganization in Bankruptcy* (West 1996; 2d ed. 2001; 3d ed. 2006) and *Fundamentals of Bankruptcy Law* (ALI-ABA 4th Ed. 1996). He has authored or co-authored twenty nine law review articles on bankruptcy law. Among his most recent published works are "One Size Fits Some: Single Asset Real Estate Bankruptcy Cases," 87 *Cornell L. Rev.* 1285-1332 (September 2002); also published in 4 Legal Scholarship Network: UCLA School of Law Research Paper Series (Mar. 20, 2002), available at <http://www.ssrn.com>; "Asset-Backed Securitization, Special Purpose Vehicles and Other Securitization Issues," (with Brendt C. Butler), 35 *U.C.C. Law Journal* 23-67 (September 2002); "Teaching Transactional Law," 27 *Calif. Bankr. J.* 295-311 (2004); and "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 -- Business Bankruptcy."

Richard B. Levin

Cravath, Swaine & Moore LLP

New York, NY



Richard Levin is a partner in Cravath's Corporate Department and serves as the Chair of its Restructuring practice. His practice focuses on creditors' rights, insolvency, reorganization and bankruptcy.

Mr. Levin has negotiated and structured complex domestic and international transactions involving distressed or insolvent companies and guided corporate debtors, creditors and acquirers through Chapter 11 and out-of-court restructurings both in negotiated resolutions and in litigation. His clients have included companies in the manufacturing, auto, technology, energy, utility, financial, telecommunications, real estate, restaurant, retail, gaming and agricultural industries.

Mr. Levin was counsel to a subcommittee of the House Judiciary Committee from 1975 to 1978, where he was one of the primary authors of the 1978 Bankruptcy Code. He currently serves as Chair of the National Bankruptcy Conference and is a Fellow of the American College of Bankruptcy. Mr. Levin has served as a consultant to the World Bank and to the Central Bank of Brazil regarding Brazil's 2005 bankruptcy legislation, as Faculty at the Federal Judicial Center's Bankruptcy Judge Workshops since 2002, and as a Lecturer in Law at Harvard Law School. He is a frequent lecturer on bankruptcy law in continuing legal education programs and is a regularly published author in the legal press.

Mr. Levin has been repeatedly cited as one of the country's leading practitioners of bankruptcy and creditor-debtor rights law by, among others, *Chambers USA: America's Leading Lawyers for Business* from 2009 through 2014; *Chambers Global: The World's Leading Lawyers for Business* in 2013 and 2014; *The Legal 500* from 2009 through 2014; *IFLR1000: The Guide to the World's Leading Financial Law Firms* from 2013 through 2015; *The Best Lawyers in America* from 2007 through 2015; *The International Who's Who of Insolvency & Restructuring Lawyers*; the *Guide to the World's Leading Insolvency and Restructuring Lawyers* in the 9th edition; and the *K&A Restructuring Register America's Top 100*, a peer listing of bankruptcy experts, in its 2002 through 2007 and 2009 through 2011 editions. He was ranked number one among the practitioners in the New York Metro area by *Super Lawyers* in 2014. Mr. Levin was named in *Lawdragon's 500 Leading Lawyers in America* from 2007 through 2010 and has been ranked in *Benchmark Litigation as a National Star and as a Local Litigation (NY) Star in Bankruptcy* from 2012 through 2015. He was also recognized by *The Legal 500* for his work in municipal bankruptcy from 2012 through 2014.

Mr. Levin received an S.B. from the Massachusetts Institute of Technology in 1972 and a J.D. from Yale Law School in 1975, where he was an Editor of the *Yale Law Journal*.

AMERICAN BANKRUPTCY INSTITUTE

James E. Millstein

Millstein & Co.

Washington, DC



James E. Millstein is the chairman of Millstein & Co., LLC, a financial advisory firm based in Washington, D.C., and an adjunct professor of law at Georgetown University Law Center, where he teaches a graduate seminar on financial regulation and the crisis of 2008. Before forming Millstein & Co., Mr. Millstein was the Chief Restructuring Officer of the U.S. Department of the Treasury, where he was primarily responsible for the management and restructuring of the government's TARP investments in AIG and Ally Financial and was a senior advisor to the Secretary in the policy-making process that resulted in the Dodd-Frank Consumer Protection and Financial Reform Bill. Before joining the Treasury in 2009, Mr. Millstein was the global co-head of Lazard's Restructuring Group, having joined Lazard in 2000 after an 18-year career at Cleary, Gottlieb, Steen & Hamilton, where he ran its Restructuring Practice. He received his bachelor's degree in politics from Princeton University in 1978, his master's degree in political science from the University of California at Berkeley in 1979 and his J.D. from Columbia University School of Law in 1982.

Harold S. Novikoff

Wachtell Lipton Rosen & Katz

New York, NY



Harold S. Novikoff is a partner and the chair of the Restructuring and Finance Department at Wachtell, Lipton, Rosen & Katz. He focuses on creditors' rights, bankruptcy, debt restructurings and financial market transactions. Mr. Novikoff has 39 years of professional experience in representing the principal lenders, bondholders and underwriters in Chapter 11 cases and out-of-court debt restructurings of a wide range of public and private companies; purchasers of and investors in financially distressed companies; and dealers and other market participants in connection with derivatives, repurchase agreements, securities loans and other financial market transactions.

In addition to his role in the firm's restructuring and finance practice, Mr. Novikoff has chaired and taught numerous continuing legal education and professional programs on a broad spectrum of financial, creditors' rights and bankruptcy-related topics, including Chapter 11 plans and disclosure statements, distressed company and debt purchases, valuation of companies in Chapter 11, special protections for financial market transactions in bankruptcy, structuring of loans and other credit transactions and avoidance actions. He is a co-author of *Collier on Bankruptcy*, and an author of numerous published articles and outlines on bankruptcy-related topics.

Mr. Novikoff is a former chair of the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, a member of the Executive Committee of the National Bankruptcy Conference, a fellow of the American College of Bankruptcy, and a member of the Steering Committee of the Board of Visitors of Columbia Law School.

Recent representations include the United States Treasury in the rescue of Fannie Mae and Freddie Mac, JPMorgan (the largest secured creditor) in the Lehman Brothers and MF Global bankruptcies cases, and major creditors of Thornburg Mortgage, Collins & Aikman, KKR Atlantic and Pacific, Axon Financial, Victoria Finance, Dreier, American Home Mortgage, 360networks and National Century Financial Enterprises.

Mr. Novikoff received his bachelor's degree with distinction from Cornell University. He received his juris doctor from Columbia University School of Law, where he was a member of the Board of Editors of the *Columbia Law Review*.

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James P. Seery, Jr.

River Birch Capital, LLC

New York, NY



James P. Seery, Jr., is a partner at the investment firm of River Birch Capital in New York. He was formerly a partner and co-head of the Corporate Reorganization and Bankruptcy Group in Sidley & Austin's New York office. Prior to joining Sidley in mid-2009, Mr. Seery was a Managing Director of Barclays Capital and, previously, the Global Head of Lehman Brothers' Fixed Income Loan business. In that position, he was responsible for managing the Lehman Brothers Fixed Income investment grade and high yield loan businesses, including commitments, global distribution, hedging, trading and sales portfolio management, and restructuring. Mr. Seery was also a member of the Lehman Brothers' Fixed Income Operating Committee and Global Credit Products Operating Committee as well as the High Yield Commitment and New Business Committees.

Before assuming management of Lehman Brothers' loan business in 2005, Mr. Seery was a senior member of the Lehman High Yield and Distressed Debt groups responsible for investing and managing proprietary distressed debt positions. From 2000 to 2004, Mr. Seery ran Lehman Brothers' restructuring and workout businesses with responsibility for management of distressed corporate investments made by Lehman Brothers.

In 1999 Mr. Seery was selected as one of the Top Restructuring Lawyers in the U.S. Under 40 by Turnarounds and Workouts. Mr. Seery graduated in 1990 from New York Law School, *magna cum laude*, where he was an editor of the Law Review, and from Colgate University in 1984. He was a member of the Board of Directors of the Loan Syndications and Trading Association from 2006 to 2008.

Sheila T. Smith

Deloitte Financial Advisory Services LLP

Boston, MA



Sheila T. Smith is a Principal in Deloitte Financial Advisory Service LLP. She leads the National Reorganization Services Practice providing workout, turnaround and bankruptcy services. In addition, Ms. Smith leads the New England Financial Advisory Services Function overseeing Corporate Finance, Forensic & Dispute, Valuation, Economic Consulting and Business Intelligence Services.

Ms. Smith has over sixteen years of professional experience in providing restructuring and financial consulting services, litigation support and corporate finance experience. Her particular focus derived from having worked in the consumer products industry is delivering cost containment and performance improvement services to return companies to profitability. Ms. Smith was the 2005 recipient of the Turnaround Management Association's International Outstanding Individual Contribution Award for her eminence in the profession.

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James H.M. Sprayregen

Kirkland & Ellis LLP

Chicago, IL



James H.M. Sprayregen is a Restructuring partner in the Chicago and New York offices of Kirkland & Ellis LLP. Mr. Sprayregen is recognized as one of the country's outstanding restructuring lawyers. Mr. Sprayregen has extensive experience representing major U.S. and international companies in and out of court as well as buyers and sellers of assets in distressed situations. He also has extensive experience advising boards of directors, and generally representing domestic and international debtors and creditors in workout, insolvency, restructuring, and bankruptcy matters. He has handled matters for clients in industries as varied as manufacturing, technology, transportation, energy, media, and real estate. *Chambers & Partners* has described Mr. Sprayregen as a "great clients' lawyer, admired for his 'unflustered ways.'" In March 2010, Mr. Sprayregen was selected by *The National Law Journal* as one of "The Decade's Most Influential Lawyers."

Mr. Sprayregen returned to Kirkland & Ellis in December 2008. He rejoined the Firm after nearly three years with Goldman Sachs, where he was co-head of Goldman Sachs' Restructuring Group and advised clients in restructuring and distressed situations. The 2009 edition of *Chambers USA, America's Leading Lawyers for Business* highlighted Mr. Sprayregen's return to Kirkland & Ellis after his nearly three years with Goldman Sachs. Mr. Sprayregen was listed as a first tier lawyer practicing in the bankruptcy/restructuring category, and was described as having an "outstanding reputation for complex Chapter 11 cases." The 2011 edition of *Chambers USA, America's Leading Lawyers for Business* recognized Mr. Sprayregen as a key individual, noting that sources refer to him as "a restructuring genius and one of the best strategists in the country." Prior to joining Goldman Sachs, Mr. Sprayregen spent 16 years at Kirkland & Ellis, where he led bankruptcy cases for United Airlines and Conesco, among many others. Some of his recent representative matters include General Growth Properties, Innkeepers USA Trust, Japan Airlines Corporation as U.S. and international counsel, The Great Atlantic & Pacific Tea Company, Visteon Corporation, Lear Corporation, The Reader's Digest Association, Corus Bankshares, Inc., Majestic Star Casino LLC, and ION Media Networks, Inc.

Mr. Sprayregen is a frequent lecturer and speaker, and has published numerous articles on insolvency, fiduciary duty, and distressed M&A issues. He also served as an Adjunct Professor at the University of Chicago Booth School of Business. He earned a J.D. from the University of Illinois College of Law and a B.A. from the University of Michigan.

Albert Togut (Co-chair)

Togut, Segal & Segal, LLP

New York, NY



For the past 40 years, **Albert Togut** has specialized in bankruptcy law to the exclusion of all other areas of practice. His law firm, established in 1980, has extensive experience in hundreds of cases representing Chapter 11 debtors, creditors committees, trustees and secured creditors. The firm was debtor's counsel in some of the largest and highest profile Chapter 11 cases, including: General Motors, Chrysler Automotive, Enron, Rockefeller Center; Ambac Financial, Loehman's, DBSD North America, Delphi, Collins & Aikman, St. Vincent's Hospitals, Charter Communications, Frontier Airlines, Loew's Cineplex, AbitibiBowater Inc. (for the BCFC Debtor); SK Global, Daewoo International (America) Corp. (which together with its Korean parent underwent the largest non-sovereign debt restructuring in history with aggregate liabilities exceeding \$70 billion); Olympia & York (World Financial Center), Allegiance Telecom, OnSite Access, Joan and David Helpen Inc; ContiFinancial Corporation, et al.; and Olympia & York World Financial Center. His firm was co-counsel to the creditors committees of American Airlines and Kodak.

He represented the retired employees committee in Nortel and has represented the Creditors' Committees and went on to be trustee of the Finley Kumble, Shea & Gould, Bower & Gardner and Berger Steingut law firms. He was lead counsel to Dewey & LeBoeuf in its Chapter 11 case and to Patton Boggs in its merger with Squire Sanders.

For 33 years, Mr. Togut has been an active member of the trustee panel maintained by the Southern District of New York. He has served as Trustee in bankruptcy in several thousand bankruptcy cases, under Chapter 11 and Chapter 7 of the Bankruptcy Code, including the \$4 billion Refco, LLC (registered commodities broker) estate; Anthracite Capital, Inc., a specialty finance company that invests in commercial real estate assets having an estimated current value of \$120 million; 313 West 77th Street Corp. (cooperative apartment building between West End and Riverside Drive in Manhattan); Kingston Square (which owned several apartment complexes subject to secured claims of approximately \$400 million.), Axona International Credit & Commerce Limited (the liquidation of a Hong Kong banking institution), for several large manufacturing companies (including Arrowhead Jewelry, Inc. and Art Steel Company, Inc.).

Mr. Togut is a Fellow of the American College of Bankruptcy, a Fellow of the International Insolvency Institute, a past Director and Officer of the American Bankruptcy Institute ("ABI") and past Chair of its New York City program, twice a member of the Committee on Bankruptcy and Reorganization of the Association of the Bar of the City of New York, a member of the International Bar Association and INSOL, and is an Advisory Board member of the LLM in Bankruptcy program at St. John's

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University School of Law, a past President of the Bankruptcy Lawyers Bar Association of New York, and for six years, Chaired a Task Force of the Business Bankruptcy Committee of the American Bar Association Section of Business Law which analyzed disclosure statement requirements and confirmation practices in Chapter 11 cases. He has written and lectured on many topics under the former Bankruptcy Act and current Bankruptcy Code and has particular expertise in conflicts of interest and ethics. He served on the ABI's fee-study commission that studied professional fees in chapter 11 business bankruptcy cases. The national commission's report provides the most comprehensive, independent look at professional fees in chapter 11 cases to date. He was also the recipient of the 2008 Prof. Lawrence P. King award and was chosen as a "Leading Lawyer" by *Chambers USA*. Mr. Togut was named as a New York Super Lawyer for 2007-2014, and named in the Top 100 lawyers in New York. In addition, he has been profiled by St. John's University School of Law as a "success story."

Bettina M. Whyte

Alvarez & Marsal LLC

New York, NY



Bettina M. Whyte is a Managing Director and Senior Adviser with Alvarez & Marsal. She is a nationally recognized leader in the financial and operational restructuring industry.

Prior to joining A&M, Ms. Whyte chaired the advisory board of Bridge Associates, LLC, a crisis management and restructuring firm. Until October of 2007, she was a Managing Director and the Head of the Special Situations Group at MBIA Insurance Corporation. Before joining MBIA, Ms. Whyte was a Managing Director of AlixPartners from 1997 to 2005.

Ms. Whyte has served as an interim CEO, COO and Chief Restructuring Officer of numerous large and mid-sized public and private corporations and partnerships. She has also been appointed by the bankruptcy courts as a Chapter 11 and a Chapter 7 Trustee and by state and federal courts as a Receiver. In these positions, she has been charged with the responsibility of daily management of the company, including implementation of cost reductions; maximization of asset productivity and development of strategies for returning products, divisions and overall operations to profitability; preparation of valuations for operations that may be divested and negotiations with potential purchasers; and negotiation of restructuring proposals with creditors and / or new sources of capital.

Additionally, Ms. Whyte has been appointed by the Bankruptcy Court as an Examiner to review allegations of fraud and mismanagement on the part of previous management / owners and to act as an independent arbitrator where disputes between parties were hindering the reorganization process. She has also served as a Liquidating Trustee where no successful plan of reorganization can be accomplished. Most recently, Ms. Whyte was retained by the Federal District Court in Eugene, Oregon to serve as a mediator and arbitrator of several complex matters related to a multibillion dollar SEC Receivership matter.

Ms. Whyte has been active in a broad range of industries, including real estate, airlines, aircraft manufacturing, not-for-profits, oil and gas, commodity trading, retail, real estate, food services, transportation, distribution, manufacturing, high technology, telecommunications, healthcare, professional services, entertainment and financial services.

Ms. Whyte serves on the boards of directors of AGL Resources (NYSE) and is a member of the Finance and Risk Management Committee and the Chair of the Compensation Committee; of Rock-Tenn Company (NYSE), where she serves on the Compensation and Audit Committees; Armstrong World Industries, Inc. (NYSE), where she sits on the Audit and Corporate Strategy Committees; and

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the board of Amerisure Insurance, a mutual insurance company, where she is the Chair of the Audit Committee and a member of the Investment and Acquisition Committee. She is on the Business Advisory Board of Solera Capital, a private-equity firm; the Advisory Board of St. John's Law School; and the Dean's Advisory Council for the Krannert School of Business at Purdue University. She is an Adjunct Professor of Law at Fordham University and has been a guest lecturer at The Harvard Business School, Kellogg School of Management at Northwestern University, Columbia Business School, The Stern School of Business at New York University and The Krannert School of Business at Purdue University. She has been featured in *BusinessWeek*, *Working Woman*, *CEO magazine*, *The Daily Deal* and *Boards and Directors* magazine, and has appeared on NBC's "Nightly News", CNN, National Public Radio and Sky Radio. Ms. Whyte is also the Past President of the American Bankruptcy Institute (ABI) and is a Fellow of the American College of Bankruptcy.

Ms. Whyte earned a bachelor's degree in industrial economics from Purdue University and a master's degree in business administration in finance and accounting from the Kellogg School of Management at Northwestern University.

Deborah D. Williamson

Cox Smith Matthews Incorporated

San Antonio, TX



Deborah Williamson is the Managing Director of Cox Smith Matthews Incorporated. She is also the senior member of the Bankruptcy and Creditors Rights Department. Deborah has been recognized for her experience in bankruptcy cases with an emphasis on her knowledge of the recent developments in bankruptcy, including co-authoring the ABI Benchnotes column for 25 years. Deborah has served as counsel for debtors, including TXCO Resources, Inc. a publicly traded exploration and production company based in the Eagle Ford shale. She has also served as committee counsel as well as individual creditors in cases around the country.

Deborah is also a frequent speaker and author, and recently co-authored *When Gushers Go Dry: the Essentials of Oil and Gas Bankruptcy*, published by the American Bankruptcy Institute. Deborah was President of the American Bankruptcy Institute in 1997-98 and received the ABI's Lifetime Achievement Award in 2011.

She serves on the Board of Directors of the American College of Bankruptcy. She is also a former Chair of the Texas State Bar Bankruptcy Law Section. Deborah was recently featured in *Texas Lawyer's Go-To Guide* as one of five lawyers in the bankruptcy category (published only every five years). Named a leader in her field by *Chambers USA* since 2003, Deborah was selected for inclusion by *Law and Politics* magazine as one of the Top 100 Lawyers in Texas (regardless of practice) since 2007. She has been selected for inclusion as one of the Top 50 Women Lawyers in Texas and one of the Top 50 Lawyers in Central Texas by *Law and Politics* since the honor's inception and in *The Best Lawyers in America* consecutively for more than a decade.

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Geoffrey L. Berman (*ex officio*)

Development Specialists, Inc.

Los Angeles, CA



Geoff Berman is a Senior Vice-President with Development Specialists, Inc. resident in its Los Angeles office. Geoff brings over 35 years' experience in all types of insolvency case administrations with a special emphasis in the area of general assignments for the benefit of creditors and post confirmation estate management through liquidating and creditor trusts under confirmed Chapter 11 Plans of Reorganization.

Notable assignments include:

- Trustee of the USA Commercial Mortgage Liquidating Trust, arising out of the largest bankruptcy in Nevada history.
- Trustee of the HNR (Horizon Natural Resources) Liquidating Trust.
- Trustee for the Syntax Brilliant Corporation Lender and Liquidation Trusts.
- Overseeing DSI's role as Liquidating Trustee for the Appalachian Fuels Creditor Trust.
- Post-Confirmation Plan Administrator and sole remaining officer of Vista Hospital Systems.
- Trustee of the Sizzler Restaurants International Creditor Trust.
- Trustee of the WATTSHHealth Foundation Creditor Trust.
- Oversight of hundreds of general assignments, including the largest general assignment in Maine history (Avian Farms, Inc.), Howard and Phil's Western Wear, Granny Goose Foods, Inc., Morgan Confections, Inc. SVTC Technologies., Medical Selfcare, Inc. and EnerTech Environmental, LLC.
- Examiner and Federal Equity Receiver cases.

Prior to joining DSI, Mr. Berman was with Credit Managers Association of California, where he was the Manager of the Adjustment Bureau and a member of the Association's senior management. Mr. Berman has previous experience with Union Bank (of California) and Mitsui Manufacturers Bank. Mr. Berman served as ABI's President from April 2011 to April 2012 and Chairman of the Board from April 2013 to April 2014. He also served as ABI's Vice President of Publications, with oversight of the *ABI Journal* and other publication projects, and as a member of ABI's Executive and Management Committees. He chaired the ABI Task Force on General Assignments, and wrote the

ABI manual on general assignments, *The ABCs of ABCs*, and has contributed chapters on ABC's to the three editions of *Strategic Alternatives for Distressed Businesses*. He also served as contributing editor and co-Executive Editor to the *American Bankruptcy Institute Journal* and has authored a law review article published in the *ABI Law Review*. He was an *ex officio* member of ABI's Ethics Task Force, which released its Report on ethical issues in bankruptcy practice at the ABI's April 2013 Annual Spring Meeting.

Mr. Berman, a certified mediator, is on the Bankruptcy Mediation Panel for the Central District of California as well as the Register of Mediators for the District of Delaware. He was a member of the inaugural faculty for the ABI's Mediation Training program, conducted at the St. John's University Hugh Carey School for Dispute Resolution in New York. He is a member of the Los Angeles and Bay Area (CA) Bankruptcy Forums, and AIRA. He speaks frequently on out-of-court and post-confirmation case administration issues.

Mr. Berman graduated with honors from the University of the Pacific, Stockton, California, with a degree in business administration (accounting and finance) and wrote an Undergraduate Honors Thesis in Finance. He also has a Juris Doctor from Southwestern University School of Law, Los Angeles, California.

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James T. Markus (*ex officio*)

Markus Williams Young & Zimmermann, LLC

Denver, CO



James Markus is a co-founder and member of Markus Williams Young & Zimmermann LLC, and is a past President of the American Bankruptcy Institute. Previously he served as Vice-president for Education of the ABI. Jim is also certified by the American Board of Certification as a Business Bankruptcy Specialist. Jim specializes in the representation of secured creditors, lessors, asset purchasers, official committees, debtors and trustees in commercial transactions, distressed debt transactions, workouts, restructurings, and Chapter 11 bankruptcy proceedings. He has a law degree from the University of Michigan Law School, J.D. and an undergraduate degree from the University of Wisconsin-Madison.

Harvey R. Miller (*ex officio*)

Weil, Gotshal & Manges LLP

New York, NY



Harvey R. Miller is currently a partner in the New York City based international law firm of Weil, Gotshal & Manges, LLP where he had been a member of the firm's management committee for over 25 years and created and developed the firm's Business Finance & Restructuring department specializing in reorganizing distressed business entities.

From September 2002 to March 2007, he was a managing director and vice chairman of Greenhill & Co.; adjunct associate professor of Law 1974-76, and adjunct professor of Law 1976 to present, New York University Law School; visiting lecturer, Yale Law School, 1983-84; lecturer in Law 2000 to present, Columbia University School of Law; member, board of visitors Columbia University School of Law through 2002; member, Dean's Council Columbia University School of Law 2003-present; member, National Bankruptcy Conference; fellow, American College of Bankruptcy; fellow of the American Bar Foundation; trustee, Committee on Economic Development.

Bar Admissions: US Court of Appeals 1st Cir.; US Court of Appeals 2nd Cir.; US Court of Appeals 3rd Cir.; US Court of Appeals 9th Cir.; Eastern District New York; New York State; Southern District New York; US Supreme Court.

Education: Brooklyn College (B.A., 1954); Columbia University Law (J.D., 1959).

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Clifford J. White III (*ex officio*)

Executive Office for United States Trustees

Washington, DC



Clifford J. White III is the Director of the Executive Office for United States Trustees. He has served in the Federal Government for 30 years, including previously as an Assistant United States Trustee, as a Deputy Assistant Attorney General within the Department of Justice, and as an official at two other federal agencies. He is an honors graduate of the George Washington University and the George Washington University Law School. Mr. White was recognized with a Presidential Rank Award for Distinguished Executive in 2009, a Presidential Rank Award for Meritorious Executive in 2006, and the Attorney General's Award for Distinguished Service in 2003.

Professor Michelle M. Harner, Reporter

University of Maryland Francis King Carey School of Law

Baltimore, MD



Michelle Harner joined the University of Maryland Francis King Carey School of Law faculty in the fall of 2009. She teaches courses in Bankruptcy and Creditors' Rights, Business Associations, Business Planning, Corporate Finance, and Professional Responsibility. Prior to joining the faculty at UM Carey Law School, where she also has served as Associate Dean for Academic Programs, Professor Harner served on the faculty of the University of Nebraska College of Law and was voted "Professor of the Year" by the upperclass students during the 2006–07 and 2008–09 academic years. Professor Harner is an elected Fellow in the American College of Bankruptcy, and an elected Member in the American Law Institute.

Professor Harner is widely published and lectures frequently on various topics involving corporate governance, financially distressed entities and related legal issues. Her publications appear or are forthcoming in the *Vanderbilt Law Review*, *Notre Dame Law Review*, *Washington University Law Review*, *Minnesota Law Review*, *Fordham Law Review* (reprinted in *Corporate Practice Commentator*), *Arizona Law Review* (reprinted in *Corporate Practice Commentator*), *Florida Law Review*, *Washington & Lee Law Review* and *Illinois Law Review*, among others. She also has published or will be publishing articles in specialty law reviews at the Moritz College of Law (The Ohio State University), Rutgers School of Law, St. John's University School of Law, University of Miami School of Law, University of Tennessee College of Law and UM Carey Law School.

Professor Harner's scholarship has been cited by numerous courts, including the United States Courts of Appeal for the First, Third, Fifth and Ninth Circuits and the United States District Courts for the Districts of Massachusetts and Nevada. Professor Harner's current research interests include shareholder and creditor activism and its impact on enterprise value; legislative responses to serial business failures and related implications for discrete industries; and the ethical implications of insolvency for directors, officers and other fiduciaries.

In March 2009 and April 2012, Professor Harner received research grants from the American Bankruptcy Institute Endowment Fund to study the role of creditors' committees in chapter 11 business bankruptcies and potential reforms to chapter 11, respectively. She also serves as a member of the Dodd-Frank Study Working Group for the Administrative Office of the United States Courts.

Professor Harner previously was in private practice in the business restructuring, insolvency, bankruptcy and related transactional fields, most recently as a partner at the Chicago office of the international law firm Jones Day. Before joining that firm in 1996, she served as law clerk to Judge

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William T. Bodoh of the United States Bankruptcy Court for the Northern District of Ohio. Professor Harner is admitted to practice law in Illinois and Ohio.

Professor Harner is an honors graduate of Boston College and was the valedictorian of her class at the Moritz College of Law at The Ohio State University, where she served as the Executive Editor of the school's law journal.

APPENDIX B: RESEARCH ASSISTANTS AND EMPIRICISTS

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In addition to the valuable work of the advisory committees and the international working group, the following individuals assisted Professor Harner in her research efforts for the Commission. The work was performed by the identified individuals and not by the firms with which they are now or currently were affiliated, although the Commission acknowledges the value of those firms allowing the individuals to devote time and effort to the Commission's project.

- Leah Barteld Clague, Senior Research Fellow for the Commission, served the Commission from July 2012 through July 2014. Ms. Clague supported Professor Harner's research for the Commissioners and assisted with preparing materials for the Commission in anticipation of field hearings, monthly meetings, and deliberations. Ms. Clague is a graduate of the University of Maryland Francis King Carey School of Law, and she is currently a Policy Analyst with the Department of Legislative Services for the Maryland General Assembly.
- Jennifer Ivey-Crickenberger, Business Law Fellow, University of Maryland Francis King Carey School of Law, served the Commission periodically through May 2014 and then again from October 2014 through December 2014. Ms. Ivey-Crickenberger supported Professor Harner's research for the Commission and the Report, and assisted Professor Harner with editing and proofing the Report. Ms. Ivey-Crickenberger is a graduate of the University of Maryland Francis King Carey School of Law.
- Sabina Jacobs, Research Fellow for the Commission, Associate with Gibson, Dunn & Crutcher LLP and formerly an Associate with Latham & Watkins LLP, served the Commission from August 2014 through December 2014. Ms. Jacobs supported Professor Harner's research for the Commission and the Report, and assisted Professor Harner with editing and proofing the Report. Ms. Jacobs is a graduate of Loyola Law School, Los Angeles, and a former law clerk for the Honorable Brendan Linehan Shannon of the U.S. Bankruptcy Court for the District of Delaware.
- Albert Togut, Managing Partner of Togut, Segal & Segal, LLP, and Samantha J. Rothman, Associate with Togut, Segal & Segal, LLP, provided research regarding the history of the federal bankruptcy laws.
- Professor Lois Lupica, University of Maine School of Law, assisted the Commission and the Reporter in drafting Section IX.B, Core and Noncore Matters in Chapter 11 Cases, and Section IX.C, Individual Chapter 11 Cases, of the Report.
- Ashish A. Shrestha, a Senior Manager with Deloitte Financial Advisory Services LLP, assisted the Commission and the Reporter with analyzing empirical data and performing empirical analyses on several issues relating to the Report.
- James Katchadurian, Executive Vice President with Epiq Bankruptcy Solutions LLC, assisted the Commission and the Reporter with analyzing empirical data and performing empirical analyses on several issues relating to the Report.
- Michael Roberts of Roberts Capital Advisors, LLC, assisted the Commission and the Reporter with analyzing empirical data and performing empirical analyses on several issues relating to the Report. Mr. Roberts is a graduate of the University of Maryland Francis King Carey School of Law.

- Professor Anne Lawton, Michigan State University College of Law, assisted the Commission and the Reporter with analyzing empirical data and performing empirical analyses on issues relating to small businesses for purposes of the Report.
- Professor Dalié Jiménez, University of Connecticut School of Law, assisted the Commission and the Reporter by sharing the results of her empirical survey regarding chapter 11 reform.
- Professor Harner also was assisted by the following current or former law students at the University of Maryland Francis King Carey School of Law: Chris Jorgenson, David Nohe, and Robert Walker. In addition, Hilary Hansen, Associate Director, Business Law Program at the University of Maryland Francis King Carey School of Law, assisted Professor Harner with proofing the Report; and Shyala Rumsey, Coordinator, Faculty Committees, and Camilla Tubbs, Acting Director, Library, at the University of Maryland Francis King Carey School of Law, assisted Professor Harner with certain graphics for the Report.

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APPENDIX C: ADVISORY COMMITTEE MEMBERS

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(Note: Members of the international working group are listed in the Report at note 53.)

ADMINISTRATIVE CLAIMS, CRITICAL VENDORS AND OTHER PRESSURES ON LIQUIDITY

Commissioners: William Brandt and James Sprayregen

Advisory Committee Members:

1. Professor Jean Braucher, University of Arizona College of Law (Tucson, AZ)
2. Deborah A. Crabbe, Foster Pepper PLLC (Seattle, WA)
3. Matthew R. Goldman, Baker Hostetler (Cleveland, OH)
4. Robert S. Hertzberg, Pepper Hamilton LLP (Detroit, MI)
5. Stephen E. Hessler, Kirkland & Ellis LLP (New York, NY)
6. Honorable Jeffrey P. Hopkins, U.S. Bankruptcy Court (S.D. Ohio)
7. Reginald W. Jackson, Vorys Sater Seymour & Pease (Columbus, OH)
8. Clifton R. Jessup, Greenberg Traurig LLP (Dallas, TX)
9. Steve B. Towbin, Shaw Gussis et al. (Chicago, IL)
10. Honorable Mary Walrath, U.S. Bankruptcy Court (D. Del)
11. Professor Todd J. Zywicki, George Mason University School of Law (Fairfax, VA)

Committee Chairs: Robert S. Hertzberg and Stephen E. Hessler

Reporter: Matthew R. Goldman

AVOIDING POWERS

Commissioners: Geoff Berman and Jack Butler

Advisory Committee Members:

1. Professor Christopher W. Frost, University of Kentucky College of Law (Lexington, KY)
2. Debra I. Grassgreen, Pachulski Stang Ziehl & Jones LLP (San Francisco, CA)
3. Honorable Stacey Jernigan, U.S. Bankruptcy Court (N.D. Tex.)
4. Bruce S. Nathan, Lowenstein Sandler PC (New York, NY)
5. John D. Penn, Perkins Coie LLP (Dallas, TX)
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6. Elliot Ganz, Loan Syndications and Trading Association (New York, NY)
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5. David Jury, United Steelworkers Union (Pittsburgh, PA)
6. Professor Thomas A. Kochan, Massachusetts Institute of Technology (Cambridge, MA)
7. Sharon L. Levine, Lowenstein Sandler, PC (Roseland, NJ)
8. Michael Nicholson, United Auto Workers (Detroit, MI)
9. David E. Rogers, McDermott Will & Emery, LLP (Washington, D.C.)
10. David R. Seligman, Kirkland & Ellis LLP (Chicago, IL)
11. Sina Toussi, VR Capital Group (New York, NY)
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3. Ephraim Diamond, Davidson Kempner (New York, NY)
4. Jay M. Goffman, Skadden Arps Slate Meagher & Flom (New York, NY)
5. Laura Davis Jones, Pachulski Stang Ziehl & Jones (Wilmington, DE)
6. Professor George W. Kuney, University of Tennessee College of Law (Knoxville, TN)
7. David A. Lander, Greensfelder, Hemker & Gale, P.C. (St. Louis, MO)
8. Richard E. Mikels, Mintz, Levin, Cohn, Ferris et al. (Boston, MA)
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Reporter: George W. Kuney

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3. Honorable Mary Grace Diehl, U.S. Bankruptcy Court (N.D. Ga.)
4. Van C. Durrer II, Skadden Arps Slate Meagher & Flom LLP (Los Angeles, CA)
5. Professor Stuart Gilson, Harvard Business School (Cambridge, MA)
6. Ronald F. Greenspan, FTI Consulting Inc. (Los Angeles, CA)
7. Melissa Kibler Knoll, Mesirow Financial Consulting (Chicago, IL)
8. David Resnick, Rothschild (New York, NY)
9. Barry W. Ridings, Lazard (New York, NY)
10. Professor Mark Scarberry, Pepperdine University Law School (Malibu, CA)

Committee Chairs: Honorable Kevin J. Carey and Barry W. Ridings

Reporters: Professor Mark Scarberry and Van C. Durrer II

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SALES OF SUBSTANTIALLY ALL OF THE DEBTORS ASSETS, INCLUDING GOING CONCERN SALES

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APPENDIX D: PUBLIC FIELD HEARING WITNESS LIST

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Ted Basta, Loan Syndications & Trading Association (New York, NY)

Michael L. Bernstein, Arnold & Porter (Washington, D.C.)

Professor S. Todd Brown, University of Buffalo School of Law (Buffalo, NY)

Howard Brownstein, The Brownstein Corp. (Conshohocken, PA)

G. Eric Brunstad, Jr., Dechert LLC (Hartford, CT)

Gerald Buccino, Buccino & Associates (Chicago, IL)

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Professor Anthony J. Casey, University of Chicago School of Law (Chicago, IL)

Maria Chavez-Ruark, Saul Ewing LLP (Baltimore, MD)

Janet Chubb, Armstrong Teasdale (Reno, NV)

Representative Howard Coble (R-NC)

Kathryn Coleman, Hughes, Hubbard & Reed (New York, NY)

John Collen, Tressler, LLP (Chicago, IL)

Honorable Melanie Cyganowski, Otterbourg, Steindler, Houston & Rosen, PC, U.S. Bankruptcy Court (E.D.N.Y.) (Ret.)

Thomas Demovic, CCE, CICP, Sharp Electronics Corp. (Mahwah, NJ)

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Honorable Robert D. Drain, U.S. Bankruptcy Court (S.D.N.Y.)

Dennis F. Dunne, Milbank, Tweed, Hadley & McCloy, LLP (New York, NY)

Daniel J. Ehrmann, Alvarez & Marsal (New York, NY)

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Brad B. Erens, Jones Day (Chicago, IL)

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Honorable Joan Feeney, U.S. Bankruptcy Court (D. Mass.)

Lisa Hill Fenning, Arnold & Porter (Los Angeles, CA)

Mark A. Gittelman, PNC Bank (Philadelphia, PA)

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John M. Haggerty, Argus Management (Grafton, MA)

John Greene, Halcyon Asset Management LLC (Boston, MA)

Jonathan N. Helfat, Otterbourg, Steindler, Houston & Rosen, PC (on behalf of CFA)

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Sandra E. Horwitz, CSC Trust Company of Delaware (Wilmington, DE)

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David R. Jury, United Steelworkers (Washington, D.C.)

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Robert Katz, Executive Sounding Board Associates, Inc. (Philadelphia, PA)

Peter S. Kaufman, Gordian Group LLC (New York, NY)

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Richard M. Kohn, Goldberg Kohn Ltd. (on behalf of CFA)

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Professor Anne Lawton, Michigan State University College of Law (Lansing, MI)

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Bryan P. Marsal, Alvarez & Marsal (New York, NY)

W. Clarkson McDow, United States Trustee, Region 4 (Ret.) (Columbia, SC)

Joseph P. McNamara, CCE, Samsung Electronics USA (Ridgefield, NJ)

Richard Mikels, Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. (Boston, MA)

Kathleen M. Miller, Smith, Katzenstein & Jenkins LLP (on behalf of IWIRC)

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A.J. Murphy, Bank of America Merrill Lynch (New York, NY)

Edward Murray, Allen & Overy LLP (London, U.K.)

Grant Newton, Association of Insolvency and Restructuring Advisors (Medford, OR)

James L. Patton, Jr., Young Conaway Stargatt & Taylor, LLP (Wilmington, DE)

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Michael P. Richman, Hunton & Williams LLP (New York, NY)

Honorable Steven W. Rhodes, U.S. Bankruptcy Court (E.D. Mich.)

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Thomas J. Salerno, Gordon & Silver LLP (Phoenix, AZ)

Sandra Schirmang, CCE, ICCE, Kraft Foods Global, Inc. (Northfield, IL)

Lee Shaiman, GSO Capital Partners, Blackstone (New York, NY)

Mark Shapiro, Barclays Capital (New York, NY)

Eric Siegert, Houlihan Lokey (Los Angeles, CA)

Professor David A. Skeel, University of Pennsylvania School of Law (Philadelphia, PA)

Professor David C. Smith, University of Virginia McIntire School of Commerce (Charlottesville, VA)

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Debora Sutor, CWA – Association of Flight Attendants (Washington, D.C.)

Jennifer Taylor, O'Melveny & Myers LLP (San Francisco, CA)

Kathleen M. Tomlin, CCE, Central Concrete Supply Co., Inc. (San Jose, CA)

Valerie Venable, CCE, Ascend Performance Materials LLC (Houston, TX)

J. Scott Victor, SSG Capital Advisors, LLC (Conshocken, PA)

Jane L. Vris, Millstein & Co. (on behalf of National Bankruptcy Conference)

Honorable Eugene R. Wedoff, U.S. Bankruptcy Court (N.D. Ill.)

Professor Jay Westbrook, University of Texas School of Law (Austin, TX)

Brady C. Williamson, Godfrey & Kahn, S.C. (Madison, WI)

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Honorable Gregg W. Zive, U.S. Bankruptcy Court (D. Nev.)

APPENDIX E: SUMMARY OF FIELD HEARINGS AND TOPICS OF DISCUSSION

AMERICAN BANKRUPTCY INSTITUTE

The October 17, 2012 field hearing was at held the Loan Syndications and Trading Association (LSTA) annual meeting in New York, New York. The hearing generally covered finance and governance concerns in chapter 11, and witnesses testified on debtor in possession (DIP) lending, distressed debt trading, and the role of secured credit. The Managed Funds Association (MFA) testified on various aspects of governance reform, suggesting changes involving the appointment of trustees, the addition of new members to a debtor's board of directors, and the appointment and management of unsecured creditors' committees.¹²³⁴ Representatives from LSTA presented data on the relationship between dip lending and reorganization, and witnesses encouraged the Commission to consider the positive role that distressed debt trading has on the market.

The Commission hosted a roundtable discussion on sales as part of a field hearing on October 26, 2012 during the annual meeting of the National Conference of Bankruptcy Judges (NCBJ) in San Diego, California. During the roundtable, witnesses recommended reviewing the time limits on the section 363 sale process, in particular for small and medium-sized enterprise cases, and with respect to plan exclusivity.¹²³⁵ Another witness discussed the scope and ambiguity in sales approved under section 363(f) of the Code.¹²³⁶ Witnesses also spoke more generally on the challenges faced by small and medium-sized enterprises using chapter 11, and on potential reforms in credit bidding and lender control provisions.

On November 3, 2012, the Commission held a field hearing at the Turnaround Management Association's annual meeting in Boston, Massachusetts. During the field hearing, witnesses provided comments on reforming the Bankruptcy Rules, the impact of *Stern v. Marshall*, the role of judicial discretion, executory contracts, and DIP lending. Comments from witnesses included: the suggestion that the time to assume or reject nonresidential real property was too short; that the speed of a section 363 sale was too quick, diminishing value to prepetition creditors; and that section 503(b)(9) protections should be abolished. One witness suggested reforms to DIP lending and amending the standard in section 1111(b) in the context of credit bidding.

The field hearing on November 15, 2012 was held at the annual convention of the Commercial Finance Association (CFA) in Phoenix, Arizona. The primary focus of the field hearing was finance, and the witnesses testified on DIP lending, the use of carve-outs, and challenges to small and medium-sized enterprises. The leadership of CFA testified on behalf of their membership and suggested the Commission study the following topics: adequate protection for secured creditors, carve-outs, the inclusion of all contract rights in the definition of secured claims, and the enforceability of inter-creditor agreements. Included among the potential reforms proposed by witnesses were: modifying the Code to allow for the statutory appointment of a sale monitor or examiner; codifying local rules

¹²³⁴See *Written Testimony of Dan Kamensky on behalf of the Managed Funds Ass'n: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012), available at Commission website, *supra* note 55.

¹²³⁵See *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 3, 2012) (recommending the 18-month limitation on exclusivity periods be amended), available at Commission website, *supra* note 55; *Oral Testimony of John Collen: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 49 (Oct. 26, 2012) (NCBJ Transcript) (stating that there are times when the absolute time limits to formulate a plan and solicit acceptances has a negative impact on the reorganization efforts of the debtor), available at Commission website, *supra* note 55; *Oral Testimony of Michael Richman: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27–29 (Oct. 26, 2012) (NCBJ Transcript) (suggesting that a section 363 sale should not be allowed within the first 90 days unless there are genuine reasons to do so), available at Commission website, *supra* note 55; *Written Statement of John Collen, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Apr. 26, 2012) (stating that the plan exclusivity time limits do not provide enough time to construct a feasible plan in many cases), available at Commission website, *supra* note 55.

¹²³⁶*Oral Testimony of Brad Erens: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 30–33 (Oct. 26, 2012) (NCBJ Transcript), available at Commission website, *supra* note 55.

to provide guidance or standards for the court to base its discretion on; clarifying sections 1129 and 1104 of the Code; codifying gifting; providing for the enforcement of fraudulent conveyance savings clauses; and shifting the burden of proof in preferential transfer claims.

During the ABI Winter Leadership Conference in Tucson, Arizona, the Commission held a field hearing on November 30, 2012. This field hearing centered on finance and governance under chapter 11, in particular the role of unsecured creditors' committees, DIP lending, the use of secondary markets, surcharges, and roll-ups. While discussing the use of secondary markets, one witness suggested that the Code should clarify that bad faith does not turn solely upon a creditor's motivation and that bad faith does not exist solely because a creditor took actions that are associated with distressed investing.

The Commission held a field hearing during the VALCON Conference in Las Vegas, Nevada, on February 21, 2013. The field hearing focused on valuation, including: different valuation methodologies; the advantages and disadvantages of judicial valuation; and the timing of valuations in chapter 11 cases. Witnesses made several suggestions to improve the valuation process used during chapter 11, including the use of the Discounted Cash Flow Analysis over the Market Test, and offering the court, at its election, access to a valuation consultant.

The March 14, 2013 field hearing was held at the spring meeting of the American College of Bankruptcy in Washington, DC. The field hearing centered on labor provisions within the chapter 11 process, in particular sections 1113 and 1114 of the Code and the impact of the proposed Conyers Bill. Recommendations for reform included: eliminating the 14-day time frame for a court hearing on section 1113 and 1114 motions; modifying the test to terminate a defined-benefit pension plan; restoring concessions if unsecured creditors ultimately get paid in full or receive value equal to 100 percent of their claims; and maintaining the right to self-help. Many of the witnesses felt that payment into pension funds or 401(k) plans should be more strongly enforced and that the labor force should be permitted to participate more actively in a debtor's business plan.

In conjunction with the ABI Annual Spring Meeting in Washington, DC, the Commission held a field hearing on April 19, 2013. This particular field hearing included testimony on professionals' fees and the challenges of small and medium-sized enterprises utilizing the chapter 11 reorganization process. Several recommendations were made to address the perception of excessive professionals' fees, including: a guideline in the present billing system that would provide a ceiling for the class's fees as a percentage of total recovery;¹²³⁷ weekly reports accompanied by memos that explain the firm's prior week's fees and expenses; or other systems that would promote greater transparency, enhance debtor supervision of professionals, and rationalize the level of professionals at the onset. Other witnesses provided insight into the unique challenges that small and medium-sized enterprises face in efforts to reorganize under chapter 11 of the Code, such as the 300-day deadline for filing a plan and disclosure statement, the section 1129(a) 45-day requirement to confirm a plan, and the application of the Absolute Priority Rule. For comparison purposes, the witnesses offered observations about the increased use of state law alternatives to chapter 11.

¹²³⁷ *Oral Testimony of Wilbur Ross: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6 (Apr. 19, 2013) (ASM Transcript), available at Commission website, *supra* note 55.

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As part of the New York City Bankruptcy Conference, the Commission held a field hearing on May 15, 2013 in New York, New York. The focus of the field hearing was the role of financial contracts and derivatives, and the use of safe harbors, in chapter 11 cases. Several recommendations for reform were proffered by the witnesses, including: tailoring the settlement payment definition to confirm more closely to Congress's original intent; imposing a self-reporting requirement on counterparties exercising safe harbors; allowing the debtor continued access to information from its clearing banks; and providing more protection to the estate's operating assets. In addition, a discussion was held surrounding the appropriateness of a three-day automatic stay for the exercise of safe harbors, the level of judicial discretion that should be granted within the definition and enforcement of safe harbors, and whether a set interest rate should apply to payouts.

The Commission heard from several witnesses regarding administrative claims and avoiding powers during its May 21, 2013 field hearing at the National Association of Credit Management conference in Las Vegas, Nevada. During a robust discussion on section 503(b)(9), one witness suggested the inclusion of drop shipment transactions in the protections of that section. Several witnesses supported changes to the preference statute to afford more protections and defenses to creditors and place more of the burden on trustees and debtors to evaluate preference claims prior to demands. Additionally, witnesses shared that the window for bringing preference actions was too broad and a cost-benefit analysis should be required when evaluating preference demands, demonstrating that pursuing the preference action would provide benefit to the unsecured creditors above the cost to pursue the action.

On June 4, 2013, the Commission held a field hearing on executory contracts, leases, and related intellectual property issues in bankruptcy at the New York Institute of Credit conference in New York, New York. A panel of witnesses represented two distinct and opposite views on the impact and value of the 210-day rule to assume or reject nonresidential leases. The witnesses also discussed the treatment of stub rents, a lessee's postpetition obligations under section 365(d)(3), and the definition of adequate assurance of future performance in the context of the assumption and assignment of leases.¹²³⁸ The panel of witnesses that discussed intellectual property issues offered suggestions to reform section 365(c) to adopt the "Actual Test," and to reform sections 365(g), (n) to adopt the *Lubrizol* decision. Further, the suggestion was made to modernize the definition of patents to include foreign-issued patents and to clarify change of control provisions.

Another field hearing of the Commission was held on June 7, 2013 in Chicago, Illinois, at the annual meeting of the Association of Insolvency & Restructuring Advisors ("*AIRA*"). The field hearing began with a report from AIRA leadership on those issues most concerning to their membership, including the format and detail of disclosure statements, the use of judicial discretion, and the revival of "KERPs." The Commission also heard from two academics regarding the interaction between labor law and the Code, and the role of governance and the value of information, in particular control discovery, in chapter 11.

¹²³⁸ *Written Statement of David L. Pollack, Ballard Spahr LLP: NYC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 10–12 (June 4, 2013) (arguing that the statutory language regarding adequate assurance of future performance in nonresidential leases is unclear, often to the detriment of commercial landlords; specifically, the statute "should be clarified to provide meaningful benchmarks which will allow those [debtors] that can survive to do so while avoiding simply delaying the inevitable for those companies which should not be either sold or reorganized"), available at Commission website, *supra* note 55.

The Commission again held a field hearing at the National Conference of Bankruptcy Judges Annual Meeting, which took place on November 1, 2013 in Atlanta, Georgia. The discourse of this hearing focused on several general proposals for reform of the Code, including: the oversight of committee work; the value of a third party reorganization professional; and the role and selection of a trustee. The Commission also heard from an academic reporting on her study of small business debtors under the current Code and proposals for reform, including modifying the definition of “small business debtor” and eliminating the 45-day plan-confirmation deadline for those debtors.

On November 7, 2013, the Commission held its first field hearing in the third judicial circuit at the 10th Annual Complex Restructuring Program at the Wharton School of Business in Philadelphia, Pennsylvania. The Commission heard from several different witnesses who testified on the role and responsibility of the debtor in possession and other parties in interest, the unique challenges faced in asbestos-related chapter 11 cases, and issues within priority rules, in particular, codifying the new value corollary of the absolute priority rule. One witness focused on reform proposals that would reduce the costs and ease the timetables applicable in small and medium-sized enterprise cases. The Commission also heard testimony on behalf of the International Women’s Insolvency and Restructuring Confederation (IWIRC). IWIRC’s testimony focused on streamlining the process for asserting section 503(b)(9) claims, including standardizing the forms and procedures for asserting such claims and establishing a timeline in which they must be asserted.

The last field hearing of 2013 for the Commission occurred at the University of Texas/Jay Westbrook Conference in Austin, Texas on November 22, 2013. The Commission heard from two representatives of the Bankruptcy Law Section of the State Bar of Texas on the results of an online survey of its members, including general suggestions for reform of the chapter 11 process like standardizing the role and practices of the U.S. Trustee across districts or regions, legitimizing the section 363 sale process, and making bankruptcy judges Article III judges. In addition to several focused proposals on reform within the Code, the Commission heard testimony regarding two larger issues: the impact of *Stern v. Marshall* and the role that venue plays in bankruptcy proceedings.

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APPENDIX F: ACADEMICS INVOLVED IN APRIL 2014 SYMPOSIUM

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Academics

Barry E. Adler, New York University, School of Law
Kenneth M. Ayotte, Northwestern University, School of Law
David G. Carlson, Yeshiva University, Benjamin N. Cardozo School of Law
Steven L. Harris, IIT Chicago-Kent, College of Law
Michelle M. Harner, University of Maryland, Francis King Carey School of Law
Gary Holtzer, Weil, Gotshal & Manges LLP
Melissa B. Jacoby, University of North Carolina, School of Law
Edward J. Janger, Brooklyn Law School
Mark Jenkins, University of Pennsylvania, Wharton School of Business
Stephen J. Lubben, Seton Hall University, School of Law
Bruce A. Markell, Florida State University, College of Law
Charles W. Mooney, Jr., University of Pennsylvania, School of Law
Juliet M. Moringiello, Widener University, School of Law
Edward Morrison, Columbia Law School
Steven L. Schwarcz, Duke University, School of Law
David A. Skeel, Jr., University of Pennsylvania, School of Law
David C. Smith, University of Virginia, McIntire School of Commerce
Charles J. Tabb, University of Illinois, College of Law
Adrian J. Walters, IIT Chicago-Kent, College of Law
Jay Lawrence Westbrook, University of Texas, School of Law

Papers Presented at April 2014 Symposium

Barry E. Adler, *Priority in Going-Concern Surplus*
Kenneth Ayotte, *Leases and Executory Contracts in Chapter 11*
David Gray Carlson & Gary T. Holtzer, *Default Penalties in Chapter 11: Enforceability of Ipso Facto Clauses in NonExecutory Contracts*
Michelle M. Harner, *The Value of Soft Assets in Corporate Reorganizations*
Melissa B. Jacoby, *Renaissance Judging and Bankruptcy Reform*
Edward J. Janger, *The Logic and Limits of Liens*
Mark Jenkins & David Carl Smith, *Creditor Conflict and the Efficiency of the Corporate Reorganization Process*
Stephen J. Lubben, *The Board's Duty to Keep Its Options Open*
Bruce A. Markell & Charles W. Mooney, Jr., *The (Il?)legitimacy of Bankruptcies for the Benefit of Secured Creditors* (presentation)
Juliet M. Moringiello, *An Essay on the Use and Misuse of Butner v. United States*

Edward R. Morrison, *Rules of Thumb for Intercreditor Agreements*

Steven L. Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*

David A. Skeel, Jr., *What is a Lien? Lessons from Municipal Bankruptcy*

Charles J. Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*

Adrian J. Walters & Ralph L. Brill, *Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom*

Jay L. Westbrook, *The Role of Secured Credit in Chapter 11 Cases: An Empirical View* (presentation)

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APPENDIX G: ADDITIONAL VIEWS ON SEVERANCE BENEFITS PRINCIPLES

Additional Views Regarding the Priority of Severance Benefits Based on Length of Service

*Prepared by Commissioner Babette A. Ceccotti*¹²³⁹

Responding to a divergence in the case law regarding the payment of severance pay as an administrative expense, the Commission has recommended a uniform rule for severance benefits calculated based on an employee's length of service. Following case law which has allocated the payment priority for severance pay based on pre- and post-petition length of service, the amount paid as an administrative expense would be limited to the amount of the benefit allocated to the post-petition services provided to the debtor. Although this approach has been followed in many cases, an allocation of severance pay priority where severance benefits are determined based on length of service is rooted in a time when courts were just beginning to grapple with the compensation features of labor agreements following the enactment of labor legislation in the 1930s. The allocation approach stems from the Third Circuit's 1947 case, *In re Public Ledger*,¹²⁴⁰ in which the court was confronted with a series of bankruptcy claim disputes over workers' pay, including whether vacation and severance benefits constituted wages and whether severance pay would be owed for a layoff caused by bankruptcy, and, if such obligations were payable, what priority would be assigned under the bankruptcy law.

The *Public Ledger* decision reflects the fledgling nature of compensation features such as paid vacation time and severance payments in the event of a layoff. In ruling on claims arising from labor agreements covering the debtor's workforce, the court decided that a contractual vacation pay entitlement of two weeks per year could be broken down into a day by day accrual, and then allocated for priority based upon the time served under bankruptcy trustee. With little analysis, the court applied the same accrual method in ruling on a separate claim for severance pay where the contract provided that severance benefits were determined based upon specified lengths of service. Thus, both severance pay and vacation pay were deemed to be accrued day by day and the priority apportioned accordingly. Taking up another contract provision which required two days' notice in advance of a layoff, or up to two days' pay in lieu thereof, the court ruled that, where the trustee failed to provide the notice, the two days' pay in lieu of notice (which was owed regardless of length of service) was an expense of administration. Although the court recognized both the two days' "notice" pay and the dismissal pay as "severance" pay owed because the employees lost their jobs, the court's differing rulings regarding priority transformed the latter into something more akin to vacation pay merely because the entitlement had a length of service component (measured by one year in the case of the vacation pay and one or more length of service determinants in the case of the severance pay).

A different approach to the same issue — the payment of severance benefits as an administrative claim — was forged by the Second Circuit, beginning with the court's ruling in *Straus-DuParquet*.¹²⁴¹ In *Straus-DuParquet*, the Second Circuit rejected the "accrual" theory of severance benefits, ruling instead that the entire severance payment constituted an expense of administration where employment was terminated postpetition, because "[s]everance pay is not earned from day to day

¹²³⁹ The views set forth in this Appendix G are the individual views of Commissioner Ceccotti.

¹²⁴⁰ *In re Public Ledger, Inc.*, 161 F.2d 762 (3d Cir. 1947).

¹²⁴¹ *Straus-DuParquet, Inc. v. Local Union No. 3, Int'l Bhd. of Elec. Workers*, 386 F.2d 649 (2d Cir. 1967).

and does not ‘accrue’ so that a proportionate part is payable under any circumstances. After the period of eligibility is served, the full severance pay is due whenever termination of employment occurs.”¹²⁴²

Rudimentary though it was in its treatment of severance pay, the distinction created by *Public Ledger* between the priority treatment of pay in lieu of notice and of severance benefits calculated based on length of service has been adopted by many courts, largely without analysis save for an acknowledgement that adopting court would not follow the Second Circuit’s rulings.¹²⁴³

Whether under labor agreements or employment policies for non-organized workforces, severance benefits are now established features of compensation programs and better developed and understood today than at the time of *Public Ledger*. Moreover, federal regulation of employee benefits under the Employee Retirement Income Security Act, enacted in 1974 (ERISA) and regulatory guidance under the Internal Revenue Code has added a wealth of depth and detail to an understanding of common forms of compensation such as retirement benefits and other benefits such as severance pay.

Recent case law addressing severance benefits in bankruptcy cases bears this out. Tackling severance pay priority as a matter of first impression in 2011, the Fourth Circuit in *Matson v. Alarcon*¹²⁴⁴ rejected the accrual approach for severance pay calculated based on length of service and followed *Straus-Duparquet* on the issue of how severance benefits are “earned” for purposes of priority treatment. Ruling that employees “earned” severance pay in full upon their termination from employment, the court cited what it termed the “ordinary” understanding of severance pay, *i.e.*, that severance pay is compensation for losses associated with the termination of employment.¹²⁴⁵

Even more recently, the Supreme Court’s 2014 decision in *United States v. Quality Stores*,¹²⁴⁶ which is cited in the Commission’s report, presented a contemporary depiction of severance pay in the course of the Court’s ruling that severance paid to employees terminated as part of the company’s bankruptcy was subject to withholding under the Federal Insurance Contributions Act (FICA). The Court recognized, matter of factly, that severance benefits were often determined by company position and seniority, and deemed a “length of service” feature paying a larger sum to more senior employees “a standard example of a company policy to reward employees for a greater length of good service and loyalty.”¹²⁴⁷ Viewed in more contemporary terms, a severance benefit calculated with reference to length of service serves particular functions that relate to the purpose of the benefit as compensation for loss of employment, rather than, as *Public Ledger* suggested, a feature defining a distinct benefit more akin to compensation an employee would receive regardless of an unforeseen contingency.

Federal regulation of employee benefits, which has increased exponentially following the enactment of ERISA (well after *Public Ledger*), reinforces the particularized view of severance pay as a benefit intended to address an unforeseen contingency — job loss — and not a benefit in the nature of a

¹²⁴²*Id.* at 651. See also *In re W. T. Grant Co.*, 620 F.2d 319 (2d Cir. 1980).

¹²⁴³See, e.g., *In re Roth Am., Inc.*, 975 F.2d 949, 957 (3d Cir. 1992); *In re Mammoth Mart, Inc.*, 536 F.2d 950, 953 (1st Cir. 1976); *Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (In re Health Maint. Found.)*, 680 F.2d 619, 621 (9th Cir. 1982).

¹²⁴⁴*Matson v. Alarcon*, 651 F.3d 404 (4th Cir. 2011).

¹²⁴⁵*Id.* at 409.

¹²⁴⁶*United States v. Quality Stores*, 134 S. Ct. 1395 (2014).

¹²⁴⁷*Id.* at 1499.

retirement or annuity benefit payable merely upon the passage of time. Notably, the distinctions that have arisen under employee benefit regulations do not depend upon whether the benefit is calculated by length of service. Under ERISA, a plan providing a severance benefit is an “employee welfare benefit plan” and not an “employee pension plan,” a distinction which exempts severance benefits from the more comprehensive requirements applicable to pension plans.¹²⁴⁸ In addition, the regulation of Voluntary Employees Beneficiary Associations (VEBAs) as tax exempt entities under the Internal Revenue Code underscores the essential attribute of severance pay as a benefit designed to compensate for unforeseen employment loss. Severance benefits are eligible to be paid through a VEBA but retirement, annuity and similar benefits are not.¹²⁴⁹ Distinguishing between severance benefits eligible for payment from a VEBA and retirement and similar benefits that are not, the regulations specify that “a benefit will be considered similar to that provided under a pension, annuity, stock bonus or profit-sharing plan [and therefore not eligible as a VEBA benefit] if it provides for deferred compensation that becomes payable by reason of the passage of time, rather than as the result of an unanticipated event.”¹²⁵⁰

These more recent developments signal that setting a uniform allocation rule which is grounded in distinctions that were articulated in the newly emerging world of bargained-for employee compensation is out of step with the Commission’s goal to update the features of the Bankruptcy Code to better reflect the current business environment — an environment which includes more modern compensation arrangements.¹²⁵¹ A uniform allocation rule also does not adequately recognize that severance benefits can vary based upon the particulars of written plan terms. In reaching its decision that severance benefits were earned in full upon termination of employment, the *Matson* court relied upon the terms of the plan, which stated a purpose consistent with the accepted understanding of severance pay, as well as the eligibility and payment rules for the benefit.¹²⁵² Following the terms of the plan may also result in disallowance of payment as a severance benefit. For example, the Second Circuit declined to apply the severance pay rule established in *Straus-Duparquet* to an executive compensation payment in *Bethlehem Steel*,¹²⁵³ ruling that the terms of the plan revealed that the payment at issue was actually a deferred compensation payment despite being labeled as severance pay.

In deference to more recent developments, particularly the Supreme Court’s pragmatic assessment of the role of severance pay “in an economy that is always changing,”¹²⁵⁴ the Commission should not

1248 See 29 U.S.C. § 1003(1) (defining the two types of plans); 29 C.F.R. § 2510.3-2 (specifying that welfare benefit plans are not subject to rules applicable to pension plans regarding, among other things, vesting, accruals and funding).

1249 See 26 C.F.R. § 1.503(c)(9)-3(d) (describing a qualifying VEBA benefit as one that “protects against a contingency that interrupts or impairs a member’s earning power.”).

1250 26 C.F.R. § 503(c)(9)-3(f).

1251 *Matson v. Alarcon* illustrates the anomalies resulting from an allocation of severance over the entire period of an employee’s service: an employee who worked for the company for over eight years — a total of 437 weeks — would receive under the company’s severance plan \$8,500 in severance compensation. Because the employee worked only 22 of the total 437 weeks during the pre-petition priority period, or 5.03% of the employee’s 437 total weeks of employment, only 5.03% of \$8,500, or \$429.31, would be allocated to the priority period. See *Matson v. Alarcon*, 651 F.3d 404, 407 (4th Cir. 2011). A benefit intended to cushion the effects of an unanticipated job loss would yield only a small fraction paid in full dollars. Moreover, such an allocation penalizes longer-term employees.

1252 See *Matson v. Alarcon*, 651 F.3d 404, 410 (4th Cir. 2011) (noting that the accrual rule favored by the trustee conflicted with the terms of the plan).

1253 *Supplee v. Bethlehem Steel Corp.*, 479 F.3d 167 (2d Cir. 2007).

1254 *United States v. Quality Stores*, 134 S. Ct. 1395, 1400 (2014).

adopt a dated allocation approach as a uniform rule. At a minimum, the law regarding the payment of postpetition severance pay should be left to continue to develop in the courts.¹²⁵⁵

¹²⁵⁵In 2005, Congress added section 503(c)(2) to the Bankruptcy Code and set limits on the payment of severance pay to insiders. Notwithstanding the divergence among the courts, Congress did not distinguish among types of severance pay or add an allocation rule to the limits under section 503(c)(2). Instead, Congress imposed the requirement that such severance payments be made only as part of a program that is generally applicable to the company's full time work force and that the payments be limited to no more than 10 times the mean severance payment to nonmanagement employees during the calendar year of such payment. These relatively recent additions to section 503 also suggest that the time for a rule limiting the payment of severance as an administrative expense based upon a length of service formula has passed.

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501 B.R. 549

United States Bankruptcy Court, S.D. New York.

IN RE: RESIDENTIAL CAPITAL, LLC, et al., **Debtors**.

Official Committee of Unsecured Creditors, on behalf of the estates of the **Debtors**, Plaintiff,
v.

UMB Bank, N.A., as successor indenture trustee under that certain Indenture, dated as of June 6, 2008; and Wells Fargo Bank, N.A., third priority collateral agent and collateral control agent under that certain Amended and Restated Third Priority Pledge and Security Agreement and Irrevocable Proxy, dated as of December 30, 2009, Defendants.
Residential Capital, LLC, et al, Plaintiffs,
v.

UMB BANK, N.A., as successor indenture trustee under that certain Indenture, dated as of June 6, 2008; and Wells Fargo Bank, N.A., third priority collateral agent and collateral control agent under that certain Amended and Restated Third Priority Pledge and Security Agreement and Irrevocable Proxy, dated as of December 30, 2009, Defendants.

Case No. 12–12020 (MG) Jointly Administered

|
Adversary Proceeding No. 13–01277(MG), Adversary Proceeding No. 13–01343 (MG)

|
Filed 11/15/2013

Synopsis

Background: Consolidated proceedings were brought for determination as to whether junior secured noteholders' collateral had value exceeding amount of their claims, such that noteholders were entitled to postpetition interest and fees, as well as for determination of noteholders' alleged right to unmatured original issue discount (OID) as addition to their secured claims and to payment on priority basis under **debtors'** proposed **Chapter 11 plan** based on alleged failure of adequate protection provided in cash collateral order. **Debtors** and creditors' committee also asserted claim for avoidance of transfers made to junior noteholders on preference theory.

Holdings: The Bankruptcy Court, [Martin Glenn, J.](#), held that:

[1] **debtors'** issuance of new notes to debenture holders as part of prepetition consensual workout, in connection with fair value debt-for-debt exchange, did not give rise to claim disallowable as one for unmatured interest;

[2] junior noteholders failed to satisfy their burden of showing that aggregate value of their collateral had diminished from date that **debtors** filed for **Chapter 11** relief, and were not entitled to adequate protection claim payable on priority basis under **plan**;

[3] mortgage loans included in property of jointly administered **Chapter 11** estates were properly valued, for purpose of determining the undersecured, secured, or oversecured nature of claims collateralized by these loans, using fair market valuation;

[4] paragraph in cash collateral order could not be interpreted as reviving junior secured noteholders' liens in collateral that had been released;

[5] refinancing opportunities associated with mortgage servicing rights that were expressly identified as “excluded” assets could not be separated from servicing rights themselves;

[6] no value could be assigned to goodwill of **debtors'** residential mortgage loan origination/servicing business as of date their **Chapter 11** petitions were filed;

[7] junior secured noteholders did not have perfected liens that were protected from strong-arm avoidance in any deposit accounts

[8] plaintiffs asserting preference claims failed to satisfy burden of showing that challenged transfers enabled junior secured noteholders to receive more than they would have received in hypothetical Chapter 7 liquidation; and

[9] “carve out” provision in cash collateral order had to be interpreted as requiring junior secured noteholders to subordinate their secured claims to payment of carve out only if there were insufficient other unencumbered assets from which carve out could be paid.

So ordered.

West Headnotes (33)

- [1] **Bankruptcy** — Claims or proceedings against estate or **debtor**; relief from stay
Bankruptcy — Bankruptcy judges

Bankruptcy court, even as non-Article-III court, had constitutional authority to enter final orders and judgment in proceeding brought for determination of junior secured noteholders' right to postpetition interest and fees as allegedly oversecured creditors, for determination of whether their claims based on original issue discount (OID) should be disallowed as claims for unmatured interest, and for whether they had adequate protection claims, as raising issues that would necessarily be resolved as part of claims-allowance process.

- [2] **Bankruptcy** — Evidence

Consolidated Financial Data Repository (CFDR) that **Chapter 11 debtors** maintained in ordinary course of their business as primary means for complying with their collateral tracking and reporting requirements under revolving loan agreement, as a Sarbanes–Oxley (SOX) compliant financial tool that was auditable, verifiable, and subject to heightened level of scrutiny, constituted a reliable and accurate business record which contained contemporaneous record of **debtors'** business transactions, and evidence of which was admissible under “business records” exception to hearsay rule as proof of what collateral had been released and what collateral was subject to junior secured noteholders' security interest in proceeding for determination of junior secured noteholders' allegedly oversecured status and purported entitlement to postpetition interest and fees.  11 U.S.C.A. § 506(b).

- [3] **Bankruptcy** — Post-petition interest

While **Chapter 11 debtors'** issuance of new notes to debenture holders as part of prepetition consensual workout, in connection with fair value debt-for-debt exchange, might result in an original issue discount (OID) for tax purposes, it did not give rise to claim for OID that was disallowable under the Bankruptcy Code as claim for unmatured interest; treating this transaction as giving rise to claim for OID that would be disallowable in bankruptcy would discourage

parties from entering into consensual workouts to alleviate financial distress and would result in increased resort to bankruptcy process.  11 U.S.C.A. § 502(b)(2).

[4] **Bankruptcy** Presumptions and burden of proof

In establishing its claim, secured creditor generally bears burden of proving amount and extent of its lien.  11 U.S.C.A. § 506(a).

[2 Cases that cite this headnote](#)

[5] **Bankruptcy** Adequate protection in general

Bankruptcy  Order of court and proceedings therefor in general

Bankruptcy  Lease

Once amount and extent of creditor's secured claim has been established, burden shifts to **debtor** seeking to use, sell, lease, or otherwise encumber creditor's collateral to prove that secured creditor's interest will be adequately protected.

 11 U.S.C.A. §§ 363,  364,  506(a).

[3 Cases that cite this headnote](#)

[6] **Bankruptcy** Determination of priority

Junior secured noteholders complaining of sufficiency of adequate protection granted to them in cash collateral order, and asserting priority claim based on this alleged insufficiency, bore burden of proof on issue.  11 U.S.C.A. § 507(b).

[7] **Bankruptcy** Determination of priority

To establish their entitlement to claim payable on priority basis under **debtors'** proposed **Chapter 11 plan**, based on alleged insufficiency of adequate protection granted to them in cash collateral order, junior secured noteholders had to show that aggregate value of their collateral diminished from the petition date to effective date of **plan**.  11 U.S.C.A. § 507(b).

[1 Cases that cite this headnote](#)

[8] **Bankruptcy** Superpriority; extension of credit or failure of adequate protection

Bankruptcy  Valuation

In assessing value of junior secured noteholders' collateral on petition date, for purposes of deciding whether aggregate value of collateral had diminished from petition date to effective date of **debtors'** proposed **Chapter 11 plan** such that noteholders were entitled to priority claim based on insufficiency of adequate protection granted to them in cash collateral order, bankruptcy court would utilize fair market valuation, rather than valuing collateral based on its liquidation value, where junior secured noteholders had entered into cash collateral stipulation to allow sale of **debtors'** assets as going concern, and where going concern valuation was consistent with **debtors'** stated purpose in filing for **Chapter 11** relief, which included "preserv[ation of] the **debtors'** [mortgage loan] servicing business on a going concern basis for sale."  11 U.S.C.A. § 507(b).

[4 Cases that cite this headnote](#)

[9] Bankruptcy ➡ Superpriority; extension of credit or failure of adequate protection

Junior secured noteholders failed to satisfy their burden of showing that aggregate value of their collateral had diminished from date that **debtors** filed for **Chapter 11** relief to effective date of **debtors'** proposed **plan**, and were not entitled to claim payable on priority basis under **plan** based on alleged insufficiency of adequate protection granted to them in cash collateral order; while **debtors** had admittedly spent money that belonged to noteholders, they did so in manner that benefited noteholders, the value of whose collateral on petition date was very substantially impaired by reason of existing defaults that prevented **debtors** from disposing of collateral at that time, but which **debtors**, through settlements and consents achieved over many months at great effort and expense, were ultimately able to sell on very favorable terms. 📄 11 U.S.C.A. § 507(b).

[2 Cases that cite this headnote](#)

[10] Bankruptcy ➡ Oversecurity

Determination as to whether junior secured noteholders were oversecured, as required for them to be entitled to postpetition interest and fees in **debtors'** jointly administered **Chapter 11** cases, did not have to be made on **debtor-by-debtor** basis, but could be made by aggregating their claims against **debtor** entities, given that no **debtor** would be required to pay junior secured noteholders more than the value of their collateral; allowing aggregation of claims and collateral more accurately reflected realities of case and of business world at large, given that junior secured noteholders' indenture, like most indentures, allowed **debtors** to move assets among their subsidiaries, and to create new subsidiaries, as long as noteholders continued to maintain their liens in these assets. 📄 11 U.S.C.A. § 506(b).

[2 Cases that cite this headnote](#)

[11] Bankruptcy ➡ In general; effect of **substantive consolidation**

Absent **substantive consolidation**, bankruptcy court will not pool assets of **multiple debtors** to satisfy their liabilities.

[12] Bankruptcy ➡ In general; effect of **substantive consolidation**

Substantive consolidation is to be used sparingly, in recognition of dangers of forcing creditors of one **debtor** to share on parity with creditors of less solvent **debtor**.

[13] Bankruptcy ➡ Adequacy of price; appraisal

When **Chapter 11 debtor's** assets are sold in arm's-length transaction, fair market value of assets is conclusively determined by the price paid.

[14] Bankruptcy ➡ Amount secured; partial security**Bankruptcy** ➡ Oversecurity

Mortgage loans included in property of jointly administered **Chapter 11** estates of **debtors** that were leading originators and servicers of residential mortgage loans were properly valued, for purpose of determining the undersecured, secured, or oversecured nature of claims collateralized by these loans, using fair market valuation, rather than a recovery analysis that discounted the figures on **debtors'** balance sheet based on assumed costs of collection, where **debtors**, in prior cash collateral order, had expressly waived right to surcharge collateral for costs of collection.

📄 11 U.S.C.A. § 506(a-c).

[15] **Bankruptcy** 🔑 **Weight and sufficiency**

While value of junior secured noteholders' security interests in equity that **Chapter 11 debtors** enjoyed in their non-**debtor** subsidiaries might perhaps be reduced based on contingent liabilities that subsidiaries faced in pending litigation, **debtors**, as parties seeking this reduction for purposes of establishing that junior noteholders were undersecured and not entitled to postpetition interest, had to present evidence of risk-adjusted equity value to account for litigation risk, and could not simply rely upon litigation risk to value equity interests at \$0.00. 📄 11 U.S.C.A. § 506(b).

[16] **Bankruptcy** 🔑 **Proceedings**

Paragraph in cash collateral order could not be interpreted as reviving junior secured noteholders' liens in collateral that had been released to allow **Chapter 11 debtors** to use it to obtain postpetition financing from another lender, where no party had ever disclosed this purported effect of paragraph in question when cash collateral order was proposed or at any contemporaneous hearing, and where junior noteholders' interpretation of paragraph, as reviving their liens and according them priority even above lien interest of lender from which **debtors** obtained this postpetition financing, would not have been agreed to by lender, which relied on priority of its lien in making postpetition advances under cash collateral order.

[17] **Bankruptcy** 🔑 **Oversecurity**

Refinancing opportunities associated with mortgage servicing rights that were expressly identified as “excluded” assets not subject to junior secured noteholders' liens, while not themselves excluded from general intangibles to which junior noteholders' liens attached, could not be separated from servicing rights themselves, and did not provide any additional security to junior secured noteholders, which bankruptcy court had to consider in assessing whether noteholders were oversecured and entitled to postpetition interest and fees. 📄 11 U.S.C.A. § 506(b).

[18] **Bankruptcy** 🔑 **Oversecurity**

No value could be assigned to goodwill of **debtors'** residential mortgage loan origination/servicing business as of date their **Chapter 11** petitions were filed, and bankruptcy court did not have to consider this value in assessing whether noteholders were oversecured and entitled to postpetition interest and fees, where value subsequently allocated to goodwill in connection with postpetition sale of **debtors'** assets was result of settlements and consents that **debtors** ultimately achieved over many months, at great effort and expense, in order to make assets ready for sale; any goodwill reflected in postpetition sale of **debtors'** assets was not shown to exist on petition date, when value of **debtors'** assets was seriously impaired and subject to steep reductions in value to account for litigation risks, potential seizure of certain mortgage servicing rights, and termination of rights and setoff by trustees of residential mortgage-backed securities. 📄 11 U.S.C.A. § 506(b).

[19] **Bankruptcy** 🔑 **Particular cases and problems**

Bankruptcy 🔑 **Oversecurity**

Any goodwill generated postpetition for **Chapter 11 debtors'** residential mortgage loan origination/servicing business was not product solely of **debtors'** use of cash collateral of junior secured noteholders but of settlements that **debtors** negotiated with government entities and trustees of residential mortgage-backed securities, such that junior

secured noteholders' liens did not attach to this postpetition goodwill as product or offspring of their cash collateral, and bankruptcy court did not have to consider postpetition goodwill in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees.  11 U.S.C.A. §§ 506(b), 552(b).

[20] **Bankruptcy** Oversecurity

Bankruptcy Evidence

Bankruptcy court could rely on extrinsic evidence, including testimony of employees of **debtors** and of other parties to ambiguous prepetition security agreement, to find that excluded assets became part of junior secured noteholders' collateral, pursuant to all-asset granting clause in security agreement, once assets ceased to be excluded assets; accordingly, bankruptcy court had to consider such previously excluded assets in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees.  11 U.S.C.A. § 506(b).

[21] **Secured Transactions** After-acquired property

Under New York law, security interest arising by virtue of after-acquired property clause is no less valid than security interest in collateral in which **debtor** has rights at the time value is given. [N.Y. Uniform Commercial Code § 9-204](#).

[22] **Bankruptcy** Particular cases and problems

Bankruptcy **Debtor** in possession

Secured Transactions Duration of filing; continuation statement

Secured Transactions Filing release

Under New York law, financing statements previously filed by junior secured noteholders continued in effect even after new financing statements were filed following release of portion of collateral securing junior noteholders' claims, and placed third parties on notice of need to investigate noteholders' interest in the released collateral after it was reacquired by **Chapter 11 debtors**, so as to prevent avoidance of security interest that noteholders possessed in this reacquired collateral pursuant to strong-arm statute. 11 U.S.C.A. § 544; [N.Y. Uniform Commercial Code § 9-502](#).

1 Cases that cite this headnote

[23] **Bankruptcy** Particular cases and problems

Bankruptcy **Debtor** in possession

Bankruptcy Oversecurity

Junior secured noteholders did not have perfected liens that were protected from strong-arm avoidance in any deposit accounts of **Chapter 11 debtors** for which an executed control agreement could not be produced, and bankruptcy court did not have to consider any such accounts in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees.  11 U.S.C.A. §§ 506(b), 544; [N.Y. Uniform Commercial Code § 9-312\(b\)\(1\)](#).

[24] **Secured Transactions** Possession by secured party without filing

Under New York law, security interest in deposit account may be perfected only by control of account. [N.Y. Uniform Commercial Code § 9-312\(b\)\(1\)](#).

[25] **Mortgages and Deeds of Trust** 🗝️ [Failure to record, effect on nonparties in general](#)

Under New York law, in order to perfect lien on real property, secured party must duly record against the title of such property a properly executed mortgage or deed of trust.

[26] **Bankruptcy** 🗝️ [Mortgages and pledges](#)

Bankruptcy 🗝️ [Debtor in possession](#)

Bankruptcy 🗝️ [Oversecurity](#)

In absence of properly executed and duly recorded mortgage or deed of trust, any lien rights that junior secured noteholders possessed in real property of **Chapter 11 debtors** was avoidable by **debtors** in exercise of strong-arm powers as **debtors-in-possession**, and did not have to be considered by bankruptcy court in assessing whether junior noteholders were oversecured and entitled to postpetition interest and fees. 📄 [11 U.S.C.A. §§ 506\(b\), 544.](#)

[27] **Bankruptcy** 🗝️ [Elements and Exceptions](#)

Bankruptcy 🗝️ [Preferences](#)

In preference-avoidance proceeding, trustee bears burden of proving each of statutory elements of preference claim, and unless trustee proves each and every one of these elements, transfer is not avoidable as preference. 📄 [11 U.S.C.A. § 547\(b\)\(1-5\).](#)

[28] **Bankruptcy** 🗝️ [Preferences](#)

When creditor asserts that it was oversecured at time of its receipt of alleged preferential transfer, such that transfer did not enable it to receive more than it would have received in hypothetical Chapter 7 liquidation, it is plaintiff's burden to refute that assertion. 📄 [11 U.S.C.A. § 547\(b\)\(5\).](#)

[29] **Bankruptcy** 🗝️ [Preferences](#)

Absent evidence regarding value of junior secured noteholders' collateral either at start of preference period or when they received allegedly preferential transfers, such as might permit bankruptcy court to determine that they were not oversecured, parties asserting preference claims failed to satisfy burden of showing that challenged transfers enabled junior secured noteholders to receive more than they would have received in hypothetical Chapter 7 liquidation. 📄 [11 U.S.C.A. § 547\(b\)\(5\).](#)

[30] **Bankruptcy** 🗝️ [Proceedings](#)

“Carve out” is provision in cash collateral order that allows for some expenditure of administrative and/or professional fees to be paid before secured creditor gets paid on its collateral.

[1 Cases that cite this headnote](#)

[31] **Bankruptcy** 🗝️ [Proceedings](#)

Unless it conflicts with provisions of the Bankruptcy Code, “carve out” provision in cash collateral order is construed by applying normal contract interpretation principles.

[2 Cases that cite this headnote](#)

[32] **Bankruptcy** 📁 **Proceedings**

Usual purpose of “carve out” in cash collateral order is to ensure the payment of specified administrative expenses from secured creditor's collateral in event that bankruptcy case goes badly, use of cash collateral is terminated, and sufficient unencumbered funds are no longer available to administer case.

[2 Cases that cite this headnote](#)

[33] **Bankruptcy** 📁 **Proceedings**

Absent anything in cash collateral order to suggest contrary intent, “carve out” provision in order had to be interpreted in manner consistent with general purpose of “carve out” provisions, as requiring junior secured noteholders to subordinate their secured claims to payment of carve out only if there were insufficient other unencumbered assets from which carve out could be paid.

[3 Cases that cite this headnote](#)

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Chapter 11

**MEMORANDUM OPINION, AND FINDINGS OF FACT
AND CONCLUSIONS OF LAW, AFTER PHASE I TRIAL**

[MARTIN GLENN](#), UNITED STATES BANKRUPTCY JUDGE

ResCap and the Creditors' Committee (the "Plaintiffs") are co-proponents of a reorganization **plan** that treats the junior secured noteholders ("JSNs") as undersecured, but would pay them the face amount of all principal and prepetition interest (\$2.222 billion, less \$1.1 billion repaid *556 postpetition). The JSNs voted against and oppose confirmation of the **plan**.

The JSNs contend they are oversecured and entitled to postpetition interest (at the default rate) and fees; they also contend they are entitled to recover an adequate protection claim of \$515 million based on alleged diminution in value of their prepetition collateral used during the case under a series of consensual cash collateral orders.¹ They also contend that their collateral should be increased as the result of an "all assets" pledge, which purportedly attaches to the **Debtors'** assets that (1) were once excluded from the "all assets" pledge but no longer are, (2) were released from the JSNs' liens but were subsequently reacquired by the **Debtors**, or (3) were never properly released from the JSNs' liens at all.

The Plaintiffs contend that (1) the JSNs are undersecured and, therefore, not entitled to postpetition interest and fees; (2) the JSNs' collateral has not declined in value since the petition date and thus the JSNs cannot assert an adequate protection claim; (3) the JSNs' collateral should be reduced from lien challenges to deposit accounts and real estate owned ("REO") assets; (4) the **Debtors'** transfers of approximately \$270 million of collateral to the undersecured JSNs in the 90 days before bankruptcy are avoidable preferences; and (5) the principal amount of the JSNs' claim must be reduced by approximately \$386 million for unmatured interest arising from original issue discount ("OID") created as part of the **Debtors'** "fair value" debt-exchange offer in 2008.

The swing between the JSNs' projected recoveries under the proposed **plan** and their "ask" is at least \$350 million, or perhaps more. In other words, the parties are fighting about a lot of money.

The legal issues are framed in two adversary proceedings, one filed by the **Debtors** and the other by the Creditors' Committee (the "Committee") after it was given standing in an order granting an STN motion. The two adversary proceedings, asserting both claims and counterclaims, were consolidated. In two earlier written decisions, the Court granted in part (sometimes with prejudice and sometimes without prejudice) and denied in part motions to dismiss some of the claims and counterclaims. (See *In re Residential Capital, LLC*, 495 B.R. 250 (Bankr.S.D.N.Y.2013), ECF Doc. # 74, and *In re Residential Capital, LLC*, 497 B.R. 403 (Bankr.S.D.N.Y.2013), ECF Doc. # 100.²) Familiarity with those decisions is assumed.

The Court established an expedited schedule for discovery and trial. The trial was bifurcated into two phases because some issues involve only the Plaintiffs and Defendants (as defined below) while other issues potentially involve other creditor constituencies in the case. The Phase I trial, conducted between October 15–23 and on November 6, 2013, was limited to disputed issues between the Plaintiffs and Defendants, to simplify the trial and limit the number of parties that felt it necessary to actively participate; the Phase II trial, involving issues potentially affecting the Plaintiffs, Defendants and a broader group *557 of parties in interest in the bankruptcy case, will be part of the contested **plan** confirmation hearing now scheduled to begin on November 19, 2013.

On August 23, 2013, the parties submitted an agreed list of issues for trial. (ECF Doc. # 84.) A Joint Pretrial Conference Order, approved by the Court on October 18, 2013, provides stipulations of fact, the parties' factual and legal contentions, and exhibit and witness lists. (ECF Doc. # 161.) All direct fact and expert sworn witness testimony was filed in advance, with the witnesses in court during the trial for cross and re-direct examination. Motions *in limine* to preclude some of the proposed expert testimony were granted in part and denied in part. (Oct. 16 Tr. 8:2–15.³) Deposition designations and counter-designations were introduced into evidence at trial mostly without objections.⁴ Voluminous exhibits were admitted in evidence at trial, mostly without objections. The parties' filed post-trial submissions on November 1, 2013, and conducted closing arguments on November 6, 2013.

This Opinion resolves the legal and factual issues in the Phase I trial. The Court completed the Opinion quickly because the outcome of the Phase I trial impacts Phase II and the confirmation hearing. This Opinion contains the Court's findings of fact

and conclusions of law pursuant to [FED. R. CIV. P. 52](#), made applicable to these adversary proceedings by [FED. R. BANKR. P. 7052](#). In making its findings of fact, the Court has resolved credibility issues and the weight appropriately given to conflicting evidence. Where contested or disputed facts or opinions were offered during trial, this Opinion reflects the Court's resolution of those disputes, whether or not the opinion specifically refers to the contrary evidence introduced by the opposing parties.

[1] All of the issues in the Phase I trial are “core,” as provided in [28 U.S.C. § 157\(b\)\(2\)](#). Because the JSNs (through UMB, the indenture trustee) submitted a proof of claim in this case, seeking to recover all principal, prepetition and postpetition interest and fees, and have asserted an adequate protection claim, all of the issues raised and resolved in these adversary proceedings necessarily must be resolved as part of the claims-allowance process. Therefore, the Court concludes that it has the constitutional authority to enter final orders and judgment in these adversary proceedings. Because issues in these adversary proceedings remain to be resolved following the Phase II trial and confirmation hearing, no final judgment can be entered now. This Opinion does include the Court's final resolution of the issues upon which it now rules.

The results of the Phase I trial can be viewed as a split decision—some issues have been resolved in favor of the Plaintiffs and some in favor of the Defendants. Subject to the outcome of the Phase II ***558** trial, the Court concludes that the JSNs' claim should not be reduced for unmaturing OID; the JSNs have failed to establish that they are entitled to recover an adequate protection claim; the JSNs have liens on certain contested collateral, including certain intangible assets, but the JSNs do not have liens on the full extent of the collateral claimed; the Plaintiffs have failed to establish that the JSNs received avoidable preferences during the preference period (as defined below); and the JSNs are undersecured and not entitled to postpetition interest and fees. As explained below, the Court concludes that (subject to the results of the Phase II trial) the JSNs are undersecured by approximately \$318 million.

I. BACKGROUND

On May 14, 2012 (the “Petition Date”), the **Debtors** filed voluntary petitions for relief under **chapter 11** of the Bankruptcy Code. Since the Petition Date, the **Debtors** have continued to operate their businesses and manage their properties as **debtors** in possession. Before filing for bankruptcy, the **Debtors** were a leading originator of residential mortgage loans and, together with their non-**Debtor** affiliates, the fifth largest servicer of residential mortgage loans in the United States, servicing approximately \$374 billion of domestic residential mortgage loans and working with more than 2.4 million mortgage loans across the United States. (Marano Direct ¶ 23.)

Defendant UMB Bank, N.A. (“UMB”) is the successor indenture trustee (in such capacity, the “Notes Trustee”) for the 9.625% Junior Secured Guaranteed Notes due 2015 issued by ResCap (the “Junior Secured Notes” or the “Notes”). (PTO ¶ 3.) Wells Fargo Bank, N.A. (“Wells Fargo”)—also a defendant—is the third priority collateral agent and collateral control agent for the Junior Secured Notes. (*Id.* ¶ 4.) Defendant Ad Hoc Group of holders of Junior Secured Notes (the “Ad Hoc Group” or the “JSNs” and, together with the Notes Trustee, the “Defendants”⁵) comprises entities that hold, or manage entities that hold, Junior Secured Notes. Membership in the Ad Hoc Group changes from time to time, as set forth in the Ad Hoc Group's statements periodically filed with the Court pursuant to [Rule 2019 of the Federal Rules of Bankruptcy Procedure](#). (*Id.* ¶ 6.)

The Defendants' claims against the **Debtors'** estates arise from Junior Secured Notes that ResCap issued pursuant to an Indenture dated June 6, 2008. (PX 1.) Those notes and the collateral securing those notes are discussed in greater detail below. As of the Petition Date, the JSNs held secured claims against ResCap, and certain of its affiliates as guarantors and grantors, in the face amount of \$2.222 billion, consisting of \$2.120 billion in unpaid principal as of the Petition Date, and \$101 million in unpaid prepetition interest. (DX ABF at 3.) The issue whether the face amount of the claim should be reduced by unamortized OID is discussed in section III.A below.

A. The Adversary Proceedings

1. Complaints and Counterclaims

In or about July 2012, the Committee began investigating what it believed to be security interests improperly asserted by the Defendants. The Committee filed its complaint on February 28, 2013 (ECF Doc. # 1), seeking among other things (1) a declaratory judgment on claims that (a) certain of the **Debtors'** property is not ***559** subject to liens or security interests in favor of the JSNs, and that (b) certain liens or security interests on property of the **Debtors** are unperfected; (2) an order avoiding the JSNs' allegedly unperfected liens on or security interests in certain property; (3) an order avoiding as preferential certain liens or security interests allegedly granted for the Defendants' benefit within 90 days of the Petition Date; (4) an order characterizing postpetition payments to the Defendants' professionals as payments of principal;⁶ (5) an order clarifying the priority of the JSNs' liens; and (6) an order disallowing the JSNs' claims pending final resolution of the Committee's complaint; and (7) an order disallowing a portion of the JSNs' claims as a result of unmatured interest allegedly arising from the 2008 debt-for-debt exchange. (*Id.*)

On May 3, 2013, the **Debtors** filed a Complaint (ECF 13–01343, Doc. # No. 1), and filed an Amended Complaint on June 19, 2013. (ECF 13–01343 Doc. # 8.) In their amended complaint, the **Debtors** seek declaratory judgments, including among other things that: (1) the JSNs' lien on general intangibles does not include any lien on the proceeds of, or value attributed to, the sale of assets pursuant to the Ocwen Asset Purchase Agreement dated November 2, 2012 (“Ocwen APA”); (2) the JSNs are not entitled to an adequate protection replacement lien; (3) the JSNs are not entitled to a lien on the assets that secure the Amended and Restated Loan Agreement, dated December 30, 2009 (“AFI LOC”), or any other collateral under the Notes Indenture (defined below) that was released by Wells Fargo; (4) the JSNs are not entitled to a lien on any recoveries of any future avoidance actions brought by or on behalf of the **Debtors'** estates; (5) the JSNs are undersecured and not entitled to postpetition interest; (6) if the JSNs are found to be entitled to postpetition interest, the interest should be awarded at the contractual nondefault rate of interest; and (7) the JSNs are undersecured because they are not oversecured at any individual **Debtor** entity.

On June 21, 2013, the Court entered an order consolidating the Committee's action with the **Debtors'** action. (ECF Doc. # 41.) On June 28, the Defendants filed an Answer, Affirmative Defenses and Counterclaims to the **Debtors'** Amended Complaint. (ECF 13–01343 Doc. # 14.) On July 29, 2013, the Defendants amended their answer and counterclaims. (ECF 13–01343 Doc. # 29.) Those amended counterclaims seek declaratory relief: (1) establishing the ownership and value of the stipulated and disputed collateral and the assets pledged in support of the JSNs; (2) establishing that the JSNs have a lien on claims against Ally Financial, Inc. (“AFI”); (3) determining the distributable value to be generated from all intercompany claims and causes of action; (4) allocating the purchase prices of **Debtor** assets sold in Court-approved sales; (5) establishing that the JSNs have a lien on the purportedly released assets; (6) determining that the use of cash collateral results in diminution in the collateral's value; (7) enforcing the **Debtors'** section 506(c) waiver; (8) defining the exact quantum of the direct costs of liquidating collateral; (9) determining the amount of the JSNs' adequate ***560** protection liens; (10) reallocating administrative expenses; (11) establishing that the JSNs are entitled to postpetition interest, default interest, fees, and expenses; (12) determining that the claims asserted by any residential mortgage backed security trust (“RMBS Trust”), monoline insurers, and RMBS certificate-holders must be subordinated; and (13) establishing that the claims against AFI identified by the Examiner⁷ appointed in the **chapter 11** proceedings and/or the property that is the subject of those claims, constitute the JSNs' collateral.

2. Motions to Dismiss

On April 30, 2013, UMB filed a motion to dismiss with prejudice Counts I, IV, V, VII, XI, XII, XIII and XIV of the Committee's complaint in their entirety, and Counts III and X in part. (ECF Doc. # 20.) UMB later withdrew its motion to dismiss certain of those counts, and on July 26, 2013, the Court heard oral argument on UMB's motion. (ECF. Doc. # 61.) The Court entered an opinion and order granting in part and denying in part UMB's motion. (ECF Doc. # 74.) In that opinion, the Court dismissed

Count V and denied without prejudice UMB's motion to dismiss Counts I, IV, and XIII. (*Id.*) See *Residential Capital*, 495 B.R. at 250.

On July 16, 2013, the Defendants filed a Motion to Dismiss Counts 3 and 5 of the **Debtors'** Amended Complaint. (ECF Doc. # 52.) That same day, the Plaintiffs filed a motion to dismiss fourteen of the Defendants' counterclaims. (ECF Doc. # 53.) The Court heard oral argument on both of those motions to dismiss on August 28, 2013, and subsequently issued a memorandum opinion and order (1) denying the Defendants' motion without prejudice, and (2) granting in part and denying in part the Plaintiffs' motion. (ECF Doc. # 100.) See *Residential Capital*, 497 B.R. at 403.

B. The Trial

On August 23, 2013, the parties entered into a Joint Statement of Issues, which the Court so-ordered. (ECF Doc. # 84.) That statement of issues contemplated a bifurcated adjudication whereby certain issues would be decided in a Phase I trial, and others would be decided in a Phase II trial (if necessary). The Phase I trial issues include (1) “[w]hether and to what extent any unamortized portion of the alleged original issue discount on the Junior Secured Note[holders]’ claim should be disallowed as unmaturing interest,” (2) “valuation of each **Debtor's** collateral ... securing the JSN claims, on a **debtor-by-debtor** basis, and the appropriate methodologies for conducting such valuation,”⁸ (3) “[w]hether and to what extent the JSNs have liens on various items of disputed collateral ... including issues related to avoidance of preferential transfers, disputed lien releases, asserted equitable liens resulting therefrom, and potential avoidance of any such equitable liens,” (4) adequate protection issues, including “[w]hether and to what extent the JSNs’ collateral has diminished in value as a result of the **Debtors'** use of cash collateral; whether the JSNs are entitled to an adequate protection claim for some or all of that value diminution; and, if the Court deems it appropriate to decide during ***561** Phase I, whether as a matter of law the JSNs might be entitled to adequate protection for any diminution in value associated with the **Debtors'** entry into the Global Settlement,” (5) “the appropriate allocation of proceeds to JSN collateral from the **Debtors'** asset sales to Ocwen and Walter” (described below), (6) “[w]hether the JSNs have a lien on all or any portion of the AFI Contribution,⁹ and/or all or any of causes of action of the **Debtors** or avoidance claims that the **Debtors** may bring that are being settled in the Global Settlement,”¹⁰ and (7) “[w]hether under  [section 506 of the Bankruptcy Code](#), the [Noteholders] may recover postpetition interest and other fees, costs, or charges under the Indenture (a) only to the extent they are oversecured by assets at a single **Debtor** entity without reference to collateral at other **Debtor** entities; (b) to the extent they are oversecured with reference to all collateral held by any **Debtor**, collectively; and/or (c) to the extent that the **Debtors** collectively have sufficient assets to pay the [Noteholders]’ claims in full and/or any particular **Debtor** is solvent.” (*Id.*)¹¹

The Court conducted a six-day hearing on Phase I from October 15–17 and October 21–23, 2013. The parties submitted the written direct testimony of 13 witnesses: Teresa Rae Farley (“Ms. Farley”), John D. Finnerty (“Dr. Finnerty”), James Gadsden (“Gadsden”), Marc E. Landy (“Mr. Landy”), Thomas Marano (“Mr. Marano”), Marc D. Puntus (“Mr. Puntus”), and Mark Renzi (“Mr. Renzi”), for the Plaintiffs; and Michael Fazio (“Mr. Fazio”), Jeffrey M. Levine (“Mr. Levine”), Ronald J. Mann (“Mr. Mann”), P. Eric Siegert (“Mr. Siegert”), John A. Taylor (“Mr. Taylor”), and Scott Winn (“Mr. Winn”), for the Defendants. Each of these witnesses was subjected to cross-examination and redirect at trial. Neither party called any rebuttal witnesses. The Plaintiffs and the Defendants sent their final exhibit lists to the Court post trial. More than 700 exhibits were admitted in evidence, some for limited purposes. The Parties filed amended consolidated deposition designations on October 29, 2013 (ECF Doc. # 179).

II. FINDINGS OF FACT

A. The Notes, the Collateral, and the Loan Facilities

1. The AFI Revolver and the Junior Secured Notes

On or about June 4, 2008, Residential Funding Company, LLC (“RFC”) and GMAC Mortgage LLC (“GMAC”), as borrowers, ResCap and certain other entities as guarantors, and certain entities as obligors, entered into a revolving loan facility (the “Revolver”) as amended from time to time. The Revolver was provided under a Loan Agreement (the “Original Revolver Loan Agreement”), dated June 4, 2008 (and amended from time to time before December 30, 2009), with AFI as initial lender and lender agent. (PTO ¶ 10; PX *562 5.) To secure the obligations under the Revolver, ResCap and certain of its subsidiaries, as grantors, granted a security interest in favor of Wells Fargo, as First Priority Collateral Agent and Collateral Control Agent, pursuant to a First Priority Pledge and Security Agreement and Irrevocable Proxy (the “Original Revolver Security Agreement”), dated June 4, 2008 (and amended from time to time before December 30, 2009). (PTO ¶ 11; PX 7.) ResCap also issued \$4.01 billion in face principal amount of Junior Secured Notes (the “Junior Secured Notes”) pursuant to an indenture dated as of June 6, 2008 (the “Notes Indenture”). (PX 1 § 1.01.) Interest accrues on the Junior Secured Notes at an annual 9.625% rate.¹² (*Id.* at 8.) ResCap issued those Junior Secured Notes with certain other entities serving as guarantors and obligors,¹³ and with U.S. Bank National Association, as the original indenture trustee. (*Id.*) To secure the obligations under the notes, ResCap and the guarantors under the Notes Indenture granted a security interest in favor of Wells Fargo—the Third Priority Collateral Agent—pursuant to the Third Priority Pledge and Security Agreement and Irrevocable Proxy (the “Original JSN Security Agreement”), dated June 6, 2008 (and amended from time to time before December 30, 2009). (PTO ¶ 13; PX 3.)

Pursuant to Original Revolver Security Agreement and the Original JSN Security Agreement, the collateral securing the Revolver was identical to the collateral securing the Junior Secured Notes. (*See* PX 7, PX 3.)¹⁴ On December 30, 2009, the Original Revolver Security Agreement, the Original Revolver Loan Agreement, and Original JSN Security Agreement were amended and restated, giving rise to the “Revolver Loan Agreement,” the “Revolver Security Agreement,” and the “JSN Security Agreement.” Following those amendments, the collateral securing the agreements remained identical. (*See* PX 8, PX 4.) The Plaintiffs contend that certain collateral was later pledged to the Revolver but not to the JSNs, which the Court will address below.

Since the collateral securing the Revolver and the Junior Secured Notes was identical, the creditors entered into an Intercreditor Agreement on June 6, 2008. (PX 2.) That agreement governs the Revolver Collateral Agent's ability to enforce rights associated with collateral. The governing documents expressly authorize the Collateral Agent, at the request of the **Debtors**, to release liens on the collateral previously securing the Revolver and the JSNs. Any lien releases executed by the Revolver Collateral Agent were binding on the Junior Secured Notes.

2. Primary Collateral and Blanket Lien Collateral

The Revolver and Junior Secured Notes were secured by two categories of collateral: *563 Primary Collateral and Blanket Lien Collateral. (PTO ¶ 12.) Primary Collateral was specifically delineated on the schedules to the AFI Revolver and served as the borrowing base under the AFI Revolver. Primary Collateral was subject to various operational and reporting requirements. (Farley Direct ¶ 24; Farley Dep. 48:14–21.)

Blanket Lien Collateral encompassed the balance of the collateral pledged as security under the AFI Revolver and not falling within the definition of “Excluded Assets.”¹⁵ (Farley Direct ¶ 25.) The Blanket Lien Collateral included assets that were not Primary Collateral, “whether [such assets were] now or hereafter existing, owned or acquired and wherever located and howsoever created, arising or evidenced.” (PX 3 at 11–12; *see also* PX 4 at 15.) All of the assets that came in to ResCap (except Excluded Assets) after the parties executed the Original JSN Security Agreement were subject to the JSNs' third priority lien due to the blanket lien. (*See* PX 3 at 11–13; PX 4 at 15–17.)

Between the Primary and Blanket Lien Collateral, the JSNs' collateral included (1) assets and property of ResCap, the Notes Guarantors, and the Additional Notes Grantors (other than Excluded Assets); ¹⁶ (2) certain equity interests, certain promissory notes and other debt instruments, certain deposit and security accounts, and certain related assets of the Notes Equity Pledgors; (3) all "Financial Assets" (as defined in Article 8 of the U.C.C.) and certain related assets of the FABS Grantors (as defined in the JSN Security Agreement); and (4) certain deposit accounts and certain related assets of the Additional Account Parties (collectively, the "JSN Collateral"). (PX 4.)

Primary Collateral could only be released if proceeds of that collateral were used to pay down the AFI Revolver or to buy replacement collateral. (See PX 1 at 56.) Blanket Lien Collateral, on the other hand, could be released without the same restrictive requirements. (Farley Direct ¶ 25; Oct. 16 Tr. 180:4–8.)

The Notes Indenture and the JSN Security Agreement combined to permit the **Debtors** to incur future indebtedness secured by liens, to conduct certain asset sales, and to release JSN Collateral so long that release was part of a transaction not prohibited by the Notes Indenture. (PX 1 §§ 1.01, 4.01, 8.04(a)(i); PX 4 § 7.) Additionally, the Intercreditor Agreement allowed the First Priority Collateral Agent to release liens on any collateral in connection with a sale or disposition of the collateral allowed under the Revolver Agreements and the Junior Secured Notes Agreement. (PX 2 § 3.1.) That collateral release would be binding on the JSNs. (*Id.*) The **Debtors** could only release JSN Collateral pursuant to the JSN Security Agreement, the Notes Indenture, and the Intercreditor Agreement. Additionally, the JSN Indenture allowed the **Debtors** to move assets among their subsidiaries, and to create new subsidiaries, as long as the JSNs continued to maintain liens on such ***564** assets. (PX 1 § 4.7 (requiring all "Significant Subsidiaries" to become "Guarantors" and thus also "Grantors" under the JSN Pledge Agreement).)

3. The AFI LOC and Released Blanket Collateral

In 2009, the **Debtors** determined that they needed additional financing to continue operating their businesses. To that end, on or about December 30, 2009, RFC and GMAC, as borrowers, entered into the AFI LOC, provided under an Amended and Restated Loan Agreement ("LOC Loan Agreement" with AFI as initial lender and lender agent). (PTO ¶ 18; PX 9.) To secure the obligations under the AFI LOC, ResCap and certain other **Debtors** granted a security interest to AFI pursuant to the Amended and Restated Pledge and Security Agreement and Irrevocable Proxy, dated December 30, 2009 (as amended from time to time, the "LOC Security Agreement") with GMAC Investment Management LLC, as secured party, and AFI, as omnibus agent, lender agent, lender and secured party. (PTO ¶ 19.) Granting that security interest to secure the AFI LOC required the First Priority Collateral Agent and Third Priority Collateral Agent to release their respective liens on certain collateral. (PX 134; Farley Direct ¶¶ 52–61.)

In 2010 and 2011, the Third Priority Collateral Agent released its lien on a variety of assets included in the JSN Collateral so the collateral could be pledged to secure the AFI LOC, including (1) certain mortgage loans, servicing rights and other assets (the "Released Loan Collateral"), and (2) certain Freddie Mac servicing advances (the "Released Advances," and collectively with the Released Loan Collateral, the "Released Blanket Collateral"). (PX 134.) To **effectuate** the releases, the Third Priority Collateral Agent executed (1) a Partial Release of Collateral, dated May 14, 2010, releasing the security interest in the Released Loan Collateral that previously secured the Junior Secured Notes, and (2) a Partial Release of Collateral, dated May 27, 2011, that released the security interest in the Released Advances that previously secured the Junior Secured Notes (together with the May 14, 2010 release, the "Blanket Releases"). (PX 130 at 1176–1305, PX 134.) The Third Priority Collateral Agent also filed U.C.C.–3 amendments that removed the Released Blanket Collateral from the collateral set forth in the original U.C.C.–1s (as amended) filed by the Third Priority Collateral Agent. (PX 131; PX 133.) Exhibits annexed to these U.C.C.–3s contained descriptions of the Released Blanket Collateral that were identical to those in the Blanket Releases themselves. (*Id.*)

The May 14, 2010 release described various categories of Released Loan Collateral, including any existing or future rights in "Subject Mortgage Loan[s]." The release defined those loans as:

Any Mortgage Loan (a) which is identified in a Mortgage Schedule delivered under the LOC Loan Agreement, (b) the carrying value of which is included in the calculation of the borrowing base included in a borrowing base report or a monthly collateral report under the LOC Loan Agreement, or (c) which is indicated in a Relevant Party's¹⁷ books and records as having been pledged to the Lender Agent.¹⁸

(PX 134 at 8.) Thus, a mortgage loan listed as AFI LOC collateral on the **Debtors'** books and records would qualify as a Subject *565 Mortgage Loan that was released. The LOC Loan Agreement defines mortgage loans to mean residential mortgage loans and any right to receive payment from the Federal Housing Administration and Department of Veterans Affairs ("FHA/VA") for insurance or guarantees of residential mortgage loans.¹⁹ (PX 9 at 87; PX 10 at 100.)

Other categories of collateral released under the Blanket Loan Release included (1) "Servicing Rights Collateral," defined as all of RFC's and GMAC's rights under existing or future agreements pursuant to which they were obligated to perform collection, enforcement or similar services to maintain and remit funds collected from mortgagees; and (2) all intangible assets and other general intangibles relating to Subject Mortgage Loans and Servicing Rights Collateral. (PX 134 at 6–8.)

The May 27, 2011 release described various categories of Released Advances that were being released from the JSNs' liens. These assets included any existing and future advances relating to mortgage loans and real estate owned property made pursuant to certain contracts with Freddie Mac. (*See* PX 130 at 1181–83.)

B. The **Debtors'** Books and Records

[2] To comply with the numerous collateral tracking and reporting requirements of the Revolver Loan Agreement, the **Debtors** developed and implemented technological systems and operational procedures. (Farley Direct ¶ 29.) Starting in 2008, the Consolidated Financial Data Repository, or "CFDR," became the **Debtors'** primary record for tracking their assets and was maintained in the ordinary course of the **Debtors'** business. (Farley Direct ¶¶ 29–30; *see also* PX 139.) The CFDR tracks various categories of assets, including without limitation, held for sale ("HFS") and held for investment ("HFI") mortgage loans, FHA/VA receivables, servicing advances, lending receivables, service fees and late charges, REO property, trading securities, and mortgage servicing rights. (Farley Direct ¶ 30 n.4.) Each asset is marked in the CFDR to reflect the facility to which it has been pledged. (Oct. 16 Tr. 194:3–10.) Because the collateral pools for the Revolver and the Junior Secured Notes were the same, the CFDR tracked the JSN Collateral by tracking the Revolver collateral. (Farley Direct ¶ 30.)

Assets comprising Primary Collateral under the Revolver Security Agreement are tracked and marked in the CFDR as pledged to the Revolver. (Oct. 16 Tr. 194:3–6.) Assets comprising Blanket Lien Collateral under the Revolver are also tracked, but before the Petition Date, those assets were marked as "Unpledged" in the CFDR because (1) the **Debtors** were not required, and the CFDR was not used, to report on Blanket Lien Collateral; and (2) Blanket Lien Collateral was not subject to the same constraints relating to use of proceeds as Primary Collateral. (Farley Direct ¶ 35.) Not all unpledged assets constituted Blanket Lien Collateral, though, because Excluded Assets under the Revolver Security Agreement and JSN Security Agreement would also be listed as unpledged. (Farley Direct ¶ 35; Oct. 16 Tr. 194:7–10.)

*566 Shortly before the Petition Date, the **Debtors** updated the CFDR to comply with stricter reporting and cash tracking requirements attendant to the bankruptcy process and recoded assets constituting Blanket Lien Collateral from "Unpledged" to "Blanket Lien Collateral." (Ruhlin Dep. 119:4–9, 155:16–156:2, 156:15–21; Farley Direct ¶ 36; Farley Dep. 115:4–14.) When the **Debtors** repurposed the CFDR in 2012 and began specifically tracking blanket lien collateral, "what [ResCap] viewed as blanket lien collateral was no longer included as unpledged. It was marked otherwise to be more specific that it related to pledged collateral in some way." (Ruhlin Dep. 119:4–9; *see also* Farley Dep. 138:4–11 ("Shortly before the filing date ... since

[ResCap was] going to have to start reporting on all assets which had been subject to the blanket lien at the time of the filing date, there was an effort undertaken to label all of the assets which were in [ResCap's] view ... subject to the blanket lien.”.)

During the trial, Ms. Farley testified that the CFDR is a Sarbanes–Oxley (“SOX”) compliant financial tool that is auditable, verifiable, and subject to a heightened level of scrutiny and attention by the **Debtors**/AFI's SOX teams and the **Debtors'** external auditors, Deloitte & Touche. (Farley Direct ¶ 43; Oct. 16 Tr. 233:1–6, 234:23–235:25.) Ms. Farley also testified that these controls were rigorous because the CFDR was a critical financial technology for the **Debtors**. (Oct. 16 Tr. 235:24–25.) Ms. Farley further detailed the strict controls on the collateral tracking process under the CFDR, including the processes for (1) designating an asset as being pledged to a particular facility; (2) changing an asset's designation; (3) reconciling any inconsistencies between the CFDR data, the general ledger, and source data submitted by various business units; and (4) submitting collateral reports under the Revolver and LOC Facility. (Farley Direct ¶¶ 30 n.4, 33–34, 38–42; Oct. 16 Tr. 194:1–10; *see also* PX 162.)

Following Ms. Farley's testimony, over the Defendants' objection, the Court admitted the CFDR in evidence as a business record maintained by the **Debtors** in the ordinary course of business. (Oct. 17 Tr. 32:17–33:17, 40:7–41:18.) The Court expressly finds that the CFDR is a reliable and accurate business record containing a contemporaneous record of the **Debtors'** business transactions concerning the assets tracked in the system. The Court also expressly finds that the Defendants' challenge to the CFDR is unpersuasive.

1. The CFDR and the Released Blanket Collateral

The CFDR constituted the **Debtors'** books and records by which they tracked collateral pledged to various facilities. Thus, collateral listed as pledged to the AFI LOC in the CFDR would meet the definition of a Subject Mortgage Loan released by the Third Party Collateral Agent (discussed above) as part of the Blanket Releases.

The JSNs claim that they have a lien on \$910 million of collateral that was identified in the CFDR as pledged to the AFI LOC on the Petition Date. That collateral is composed of categories of assets that were released under either of the Blanket Releases.²⁰ (Farley Direct ¶ 62.) The ***567** JSNs argue that other evidence of the release of this \$910 million of JSN Collateral should exist, including schedules of mortgage loans, notices of collateral additions to the LOC Loan Agreement, and electronic templates used to update the CFDR. The **Debtors**, though, either did not maintain all these documents or did not locate them in their searches during discovery. (*See* ECF 13–01343 Doc. # 117; *see also* Oct. 16 Tr. 237:6–239:14.)

Regardless, there is no dispute that \$910 million of collateral is listed in the CFDR as pledged to the AFI LOC; nor is there any dispute that the \$910 million comprises categories of assets that were released under the Blanket Releases. In ruling on the motions to dismiss, the Court held that the description of the collateral covered by the releases satisfied the requirements of the  **Uniform Commercial Code** (“U.C.C.”) section 9–108(b). *Residential Capital*, 497 B.R. at 418. Therefore, the Court finds that the \$910 million was effectively released, and no further evidence is necessary to support those releases. The absence of the additional records sought by the Defendants is not sufficient to overcome the evidence that was introduced at trial. The Court expressly finds that a preponderance of the evidence supports the finding that the \$910 million of collateral was released from the JSNs' lien and pledged to the AFI LOC.

C. Events Leading Up to the **Debtors' Bankruptcy**

In August 2011, the **Debtors** began to contemplate out-of-court restructuring opportunities, a potential **chapter 11** filing, financing alternatives and asset sales. To that end, in October 2011, ResCap retained Centerview Partners LLC (“Centerview”) to assist in this process. (Puntus Direct ¶¶ 1, 16, 40, 41, 43; Marano Direct ¶ 28.) In December 2011 and January 2012, faced with significant debt maturities coming due in spring 2012, the **Debtors** and Centerview began evaluating, and launched a process to obtain, a stalking horse bid(s) for a **chapter 11** sale of all or a substantial portion of the **Debtors'** assets. (Puntus

Direct ¶¶ 3, 16, 44; Marano Direct ¶ 29.) Contemplating a potential bankruptcy filing, the **Debtors** wanted to obtain **debtor-in-possession** (“DIP”) financing, secure a stalking horse bid, and continue to work with government-sponsored entities (“GSEs”) and regulators to maintain the **Debtors’** GSE mortgage servicing rights (“MSRs”). (Marano Direct ¶ 3 1.) The **Debtors** also wanted to resolve potential claims against AFI to obtain AFI’s support for the business and resolve litigation threats asserted by RMBS trustees. (*Id.*)

1. Stalking Horse Bids

On or about January 23, 2012, Centerview launched a marketing process for the **Debtors’** assets. (Puntus Direct ¶ 48.) After developing a list of potential bidders, Centerview contacted five potential bidders and negotiated nondisclosure agreements with each one. (*Id.*) Centerview made clear that the **Debtors** would consider bids for any and all asset combinations, including bids on individual assets. (*Id.*) *568 Centerview also opened a data room to facilitate bidder due diligence, and the **Debtors** held multi-day management presentations with three of the five potential bidders. (*Id.*)

In February 2012, Centerview received three preliminary indications of interest from (a) Nationstar Mortgage LLC (“Nationstar”) (PX 27), (b) Ocwen Loan Servicing LLC (“Ocwen”) (PX 25), and (c) a certain undisclosed financial bidder (PX 17). The financial bidder’s letter of intent (“LOI”) included a bid of \$1.5 billion for the **Debtors’** mortgage loan origination and servicing assets (the “Servicing and Origination Assets”) and portions of the **Debtors’** whole loan portfolio (the “Whole Loan Portfolio”). Nationstar also submitted an LOI, which included a bid of \$2.6 billion for a substantial portion of the **Debtors’** assets. (Puntus Direct ¶ 49.) Ocwen’s initial LOI was a bid of \$1.426 billion to acquire solely the **Debtors’** private label securitization (“PLS”) MSRs and associated advances. (*Id.*) The **Debtors** and their advisors determined that proceeding with two of the three bidders—Nationstar and the financial bidder—was most prudent. (*Id.* ¶ 50.) Centerview then approached each of the two with a detailed request for supplemental information. (*Id.*) To that end, on February 22, 2012, Centerview sent a letter to Fortress Investment Group LLC (“Fortress”)—Nationstar’s primary shareholder—requesting additional clarification related to Nationstar’s bid. (PX 366.) Centerview asked Nationstar to clarify how it would allocate its bid among the purchased assets, “including but not limited to a separate allocation for each of the financial assets (MSR, advances, whole loan portfolio) as well as the servicing and origination platforms, respectively.”²¹ (*Id.*) In its response to Centerview’s questions about bid allocation, Fortress specified that it would allocate no value to either the consumer lending or servicing platforms. (PX 28 at 2.)

Nationstar submitted a revised LOI on February 28, 2012, increasing the purchase price on assets included in its initial bid by \$100 million, and expanding the assets purchased to include GSE and PLS advances. (Puntus Direct ¶ 5 1.) It also increased its total bid for the **Debtors’** mortgage loan origination and servicing assets and Whole Loan Portfolio to \$4.2 billion for the **Debtors’** mortgage loan origination and servicing assets and Whole Loan Portfolio. (*Id.*) Nationstar’s bid on the Whole Loan Portfolio was contingent on AFI providing better-than-market debt financing for such portfolio. (*Id.*) After this bid, the **Debtors** decided to proceed with Nationstar as the exclusive bidder on the assets. (*Id.* ¶ 52.) In early March 2012, the **Debtors** and their advisors negotiated the terms of the asset purchase agreement with Nationstar (the “Nationstar APA”), and Nationstar completed its analysis of the **Debtors’** business. (*Id.* ¶ 55.)

During April and May of 2012, AFI decided not to provide Nationstar debt financing related to the **Debtors’** Whole Loan Portfolio, and offered its own bid of \$1.4 to \$1.6 billion to acquire those assets, depending on whether the sale was **effectuated** through a section 363 sale or **chapter 11 plan**. (*Id.* ¶ 56.) AFI’s decision not to provide financing caused the value of Nationstar’s overall bid to decrease. (*See* PX 52 at 6.) The **Debtors’** professionals determined that AFI’s bid to acquire the Whole Loan Portfolio was superior to Nationstar’s *569 bid for those assets, particularly because AFI was not seeking any stalking horse protections in connection with the sale and had submitted a draft asset purchase agreement with very favorable terms for the **Debtors**. (Puntus Direct ¶ 56.) Thus, the **Debtors** and their advisors negotiated the terms of an asset purchase agreement with AFI (the “AFI APA”).

The **Debtors'** Board of Directors approved both APAs. (*Id.* ¶ 57.) On May 13, 2012, both APAs were executed and delivered by the parties. (*Id.*) On the Petition Date, the **Debtors** filed two stalking horse bids with the Bankruptcy Court: Nationstar's \$2.3 billion stalking horse bid for the **Debtors'** mortgage loan origination and servicing assets (encompassed in the Nationstar APA), and AFI's \$1.4 to 1.6 billion bid for the **Debtors'** Whole Loan Portfolio (encompassed in the AFI APA). (Puntus Direct ¶ 57; Marano Direct ¶ 58.)

2. Communications and Settlements with Various Parties

During the prepetition auction process, the **Debtors** regularly communicated with the GSEs concerning the proposed agreement and **plans** for maintaining the **Debtors'** origination and servicing operations as a going concern until closing of the final sale to preserve the value of the MSRs and associated advances. (Marano Direct ¶ 50; Puntus Direct ¶ 45.) Through these regular contacts, the **Debtors** convinced the GSEs that the **Debtors** could sell the assets without damaging the MSRs and associated advances. (Puntus Direct ¶ 46.) The stakes were high: if the GSEs had concluded that ResCap could not operate or credibly pursue an orderly sale of the mortgage servicing assets, and that the GSE-related assets might therefore have been subject to liquidation, the GSEs would raise the cost of doing business and seize their assets. (Marano Direct ¶ 51.) By obtaining financing, use of cash, continuity of management through the end of sale, and a stalking horse bidder, the **Debtors** reassured the GSEs that during the **chapter 11** sale process, the **Debtors'** business would continue to function as usual pending the sale. (*Id.*)

Before the Petition Date, the **Debtors** negotiated a settlement with the Department of Justice, the Department of Housing and Urban Development, and the attorneys general of 49 states (the “DOJ/AG Settlement”) to resolve potential claims arising out of origination and servicing activities and foreclosure matters. (*Id.* ¶ 7.) The DOJ/AG Settlement required that the **Debtors** pay approximately \$110 million in cash and provide various specified forms of borrower relief with a value of at least \$200 million and that the **Debtors**—and any purchaser of the **Debtors'** assets—implement a remedial program of loan modification and enhanced servicing measures, both subject to ongoing regulatory monitoring and oversight, and imposed increased operational costs. (*Id.* ¶ 53.) Also before the bankruptcy filing, the **Debtors** entered into a consent order settling an investigation by the Federal Reserve Board (the “FRB Consent Order”) arising out of the same general facts as the DOJ/AG Settlement. (*Id.* ¶ 54.) The terms of the FRB Consent Order required ResCap to pay a penalty of \$207 million, as well as to enhance various aspects of their origination and servicing business, including their compliance and internal audit programs, internal audit, communications with borrowers, vendor management, employee training, and oversight by the Board of Directors. (*Id.*) The Consent Order required the **Debtors**—and any purchaser of the **Debtors'** assets—to maintain *570 compliance with the terms of the order.²² (*Id.*)

3. Prepetition Settlements and **Plan** Support Agreements

Before the Petition Date, the **Debtors** entered into **plan** support agreements with AFI and certain other parties in interest—including certain of the current Ad Hoc Group members—whereby the parties committed to support, subject to certain terms and conditions, the **Debtors'** effort to pursue a **chapter 11 plan** pursuant to the terms provided in the **Plan** Term Sheet, dated May 14, 2012 (the “Prepetition **Plan** Term Sheet”). (PX 432.) The Prepetition **Plan** Term Sheet contemplated, among other things, that AFI would make a cash contribution in exchange for estate and third party releases. (PTO ¶ 24.) The **Debtors** and AFI reached a prepetition settlement approved by the ResCap board on May 13, 2012 (the “Original AFI Settlement”). (Marano Direct ¶ 40.) That settlement was memorialized in a **Plan** Sponsor Agreement. (*Id.*) Under the terms of the Original AFI Settlement, AFI agreed to pay the **Debtors** \$750 million, continue to support the **Debtors'** origination business in **chapter 11**, provide a stalking horse bid for the Whole Loan Portfolio, provide DIP financing, and continue to provide the **Debtors** the shared services it needed to run its business. (*Id.* ¶ 41.) The Original AFI Settlement and **Plan** Sponsor Agreement also provided for the automatic termination of the agreements if the Court did not approve a **chapter 11 plan** on or before October 31, 2012. AFI and the **Debtors** agreed to monthly waivers of this automatic termination through February 28, 2013. (*Id.* ¶ 41; Puntus Direct ¶ 35.)

Under the **plan** support agreement entered into with the JSNs (the “JSN PSA”), the JSNs would have waived all rights to postpetition interest through December 31, 2012, so long as no unsecured creditor received postpetition interest, the JSN PSA did not terminate, and the effective date of the **plan** occurred by December 31, 2012, or (1) the closing of contemplated asset sales occurred by December 31, 2012, and (2) the effective date of the **plan** occurred by March 31, 2013. (Puntus Direct ¶ 33.) The JSN PSA also would have provided that AFI would subordinate a portion of its liens and claims to the JSNs. (*Id.*)

At the same time that the **Debtors** were negotiating with AFI, they were also negotiating with the trustees of certain RMBS trusts (the “RMBS Trusts”) for which the **Debtors** acted as sponsor, depositor, or in a similar capacity. (*Id.* ¶ 37.) These negotiations related to resolution of approximately \$44 billion of potential liability for representation and warranty and servicing claims arising out of the **Debtors**’ private-label residential mortgage backed securities. (Marano Direct ¶ 43.) The **Debtors** believed that resolving these private-label securities claims was crucial to enhancing the value of the **Debtors**’ assets for a potential sale. (*Id.*) The overhang of this litigation exposure had impeded the **Debtors**’ sale efforts in the years before the **chapter 11** filing and would have diminished the value the **Debtors**’ creditors could have obtained in a **chapter 11** sale. (*Id.*) Further, the RMBS Trustees (the “RMBS Trustees”) threatened to assert the right to withhold servicing advances owed to the **Debtors** as an offset against origination and servicing liabilities allegedly owed to them. (*Id.*)

In May 2012, the **Debtors** reached a proposed settlement with the institutional *571 investors holding a substantial stake in the RMBS Trusts (the “RMBS Settlement”). (*Id.* ¶ 44.) ResCap’s board of directors approved that agreement on May 13, 2012. (*Id.*)

With the stalking horse bids, proposed settlements, and **plan** support agreements in place, the **Debtors** filed their **chapter 11** cases on May 14, 2012. Any notion that the Court was being presented with a pre-packaged bankruptcy was short-lived, however, and these cases rapidly descended into warfare threatening the **Debtors**’ ability to continue operating as a going concern.

4. Termination of the Initial **Plan** Support Agreements

By late September 2012, two events occurred that altered the calculus of the JSNs who supported the prepetition PSA. (Siegert Direct ¶ 12.) First, with the auction still a month away, there was no longer any possibility of an expedited distribution upon a rapid sale closing. (*Id.*) Second, the Committee challenged certain of the JSNs’ liens within the challenge period prescribed by the Cash Collateral Order. (*Id.*) The Ad Hoc Group then terminated the prepetition term sheet and inserted an express reservation of rights regarding adequate protection and allocation of expenses in each extension of the Cash Collateral Order. (*Id.*)

D. The Cash Collateral Order

To keep their business operating as **debtors-in-possession**, the **Debtors** sought to obtain postpetition financing and authorization to use the cash collateral encumbered by existing debt facilities. (Marano Direct ¶ 33; Puntus Direct ¶ 17.) The continued funding would allow the **Debtors** to (1) continue to issue loans and offer loan modifications to thousands of borrowers; (2) continue to service mortgages and make advances associated with such servicing obligations; (3) comply with the Federal Reserve and FDIC consent order; (4) comply with the DOJ/AG Settlement; (5) comply with the agreements that had been entered into with the GSEs mandating the care with which their loans should be serviced and refinanced, and repurchase loans from the GSEs; and (6) maintain hundreds of employees through retention payments so that delinquencies would not increase and thus diminish the value of, and jeopardize the sale of, the **Debtors**’ MSRs and other assets. (Marano Direct ¶ 34.) For example, the **Debtors** needed to continue funding their servicing advance obligations for the RMBS and other PLS, as well as GSE loans. (*Id.* ¶ 35.) With respect to the GSE loans, the GSEs actually owned the **Debtors**’ servicing rights, so if the **Debtors** failed to make the requisite advances, the GSEs could have revoked the **Debtors**’ servicing rights, and re-assigned those rights to another company. (Marano Direct ¶ 35; Puntus Direct ¶ 19.)

The **Debtors** ultimately obtained DIP financing facilities from Barclays Bank PLC and AFI, as well as consensual use of cash collateral from their prepetition lenders, including the JSNs. (Marano Direct ¶ 37.) On May 14, 2012, the **Debtors** filed motions seeking authorization to (1) enter the Barclays postpetition financing facility (the “Barclays DIP Facility”); (2) make postpetition draws under the AFI LOC up to \$200 million; and (3) use cash collateral securing each of the Revolver, the AFI LOC, and the Junior Secured Notes to fund the cash needs related to operations and assets of each of the respective collateral pools. (*Id.*; Puntus Direct ¶ 28.) The motions were approved on an interim basis on May 15, 2012, and were approved on a final basis, with the consent of the JSNs and AFI, pursuant to orders entered on *572 June 25, 2012 (the “Cash Collateral Order”). (PX 76; Marano Direct ¶ 37.)

Under the Cash Collateral Order, the **Debtors** were authorized to use cash collateral in accordance with the Forecasts (as defined in the Cash Collateral Order), and the JSNs were protected to the extent of the aggregate diminution in value of the JSN Collateral. (PTO ¶ 29.) Among other things, the JSNs were granted adequate protection liens on all of the collateral securing the AFI Revolver, the AFI LOC, and all of the equity interests of the Barclays DIP Borrowers. (PX 76.)

The parties dispute whether, in determining an adequate protection claim based on diminution in value of collateral, the value of the collateral at the Petition Date should be determined by the foreclosure value of the collateral in the hands of the secured creditor (as argued by the Plaintiffs), or by the going concern value of the collateral in the hands of the **Debtors** (as argued by the Defendants). The legal issue is discussed below in section III.B.3. The Defendants' expert Mr. Siegert testified that when negotiating the Cash Collateral Order, the parties never discussed that adequate protection and diminution in value of JSN Collateral would be determined using foreclosure value. (Oct. 23 Tr. 195:9–13.) According to Mr. Siegert, that would have been contrary to the spirit of the negotiations, which were aimed at easing the **Debtors'** bankruptcy filing. (DX AIJ at 7.)

The Forecasts provided for the pro rata allocation of the cash disbursements during the relevant period to various silos of assets securing the **Debtors'** various secured credit facilities, as well as to unencumbered assets. (Puntus Direct ¶ 26.) The **Debtors** delivered updated Forecasts to the JSNs and AFI every four weeks as required by the Cash Collateral Order, and, although the JSNs did not have consent rights, at no point during the case did they object to any Forecast. (*Id.*) The Cash Collateral Order also obligated the **Debtors** to deliver to the JSNs a 20-week forecast of anticipated cash receipts and disbursements for the 20-week period. (PX 76 at 22.) The **Debtors** were only permitted to use cash collateral for the “purposes detailed within the Initial 20-Week Forecast and each subsequent Forecast.” (*Id.* at 23–24.)

The Cash Collateral Order contained a waiver of the **Debtors'** right to surcharge against prepetition collateral pursuant to  Bankruptcy Code section 506(c). (PX 76 at 42–43.) Specifically, the Cash Collateral Order states that: “[N]o expenses of administration of the **Chapter 11** Cases or any future proceeding that may result therefrom, including liquidation in bankruptcy or other proceedings under the Bankruptcy Code, shall be charged against or recovered from the Prepetition Collateral and [Cash] Collateral pursuant to sections 105 or  506(c) of the Bankruptcy Code....” (*Id.*) The Cash Collateral Order also expressly waived the “equities of the case” exception contained in section 552(b) of the Code. (*Id.* at 35.)

The **Debtors** negotiated several extensions regarding the use of the cash collateral of AFI and the JSNs, including a stipulation entered on June 28, 2013. (ECF 12–12020 Doc. # 4115.) On July 10, 2013, the Court entered the Stipulation and Order in Respect of the **Debtors'** Motion for Entry of an Order to Permit the **Debtors** to Continue Using Cash Collateral (ECF 12–12020 Doc. # 3374) (the “Cash Collateral Stipulation”) among the **Debtors**, AFI, and the JSNs, which terminated the use of cash collateral effective as of July 11, 2013, with certain limited exceptions. (PX 85 ¶ 2.)

The **Debtors** also negotiated a “Carve Out” in the Cash Collateral Order (PX 76 *573 at 31– 32.) The Cash Collateral Stipulation served as the Carve Out Notice. No party disputes that a  section 506(c) waiver was provided for the benefit of the JSNs. The parties dispute whether the JSNs are entitled to an adequate protection claim for amounts of cash collateral expended by the **Debtors** consistent with the agreed budget under the Cash Collateral Order. The issue also remains whether the **Debtors** may use an additional \$143 million of the JSNs' cash collateral covered by the Carve Out in the Cash Collateral Order after

the termination of the use of cash collateral where sufficient unencumbered cash is available to make the payments. The issue is addressed below in section III.D.8.

E. Stipulation of Liens under the Cash Collateral Order

In the Cash Collateral Order, the **Debtors** stipulated that the JSNs' collateral included, but was not limited to, all categories of assets identified in the "Ally Revolver" and "Blanket" columns on Exhibit A to the Cash Collateral Order. (PTO ¶ 28.) The **Debtors** further stipulated, pursuant to paragraph 5(g) of the Cash Collateral Order, that security interests granted to the JSNs "are valid, binding, perfected and enforceable priority liens on and security interests in the personal and real property constituting 'Collateral' under and as defined in the Junior Secured Note Documents." (PX 76 at 11–12.) Under the Cash Collateral Order, the "Junior Note Documents" included the JSN Security Agreement, the Notes Indenture, "and all other documents executed in connection therewith." (*Id.* at 4) The Defendants contend that, under paragraph 5(g), the **Debtors** stipulated that the JSNs' liens extend to all collateral to which a security interest was initially granted, including the AFI LOC Collateral that was previously released by the Third Priority Collateral Agent under the Blanket Release. (PTO JSN Contentions ¶ 18.) The JSNs' witness, Mr. Siegert—the lead engagement partner for Houlihan Lokey Capital, Inc. ("Houlihan")—testified that as of the Petition Date, he had no belief that the **Debtors** stipulations in paragraph 5(g) would revive the JSNs' previously released liens. (Oct. 23 Tr. 102:4–6, 102:19–24, 105:3–25, 115:4–8, 125:12–126:15, 126:23–127:21.) Mr. Siegert explained that if counsel for the JSNs had concluded that paragraph 5(g) would revive more than \$1 billion of AFI LOC Collateral, that would have been material information for Houlihan and the Ad Hoc Group to know, as well as a material factor in estimating the value of the JSNs' liens. (Oct. 23 Tr. 127:25–128:16.) But Houlihan's May 14, 2012 public presentation (the "May 14 Presentation") that presented an estimation of the JSNs' recovery on their prepetition collateral did not incorporate or disclose the existence of the billion dollars of AFI LOC Collateral. (PX 169; Oct. 23 Tr. 128:17–21; 132:18–133:4.) Mr. Siegert testified that if Houlihan had known that paragraph 5(g) revived \$1 billion worth of JSNs' liens, it would have incorporated that fact in the May 14 Presentation. (Oct. 23 Tr. 128:23–133:4.)

Further, in paragraph 5(g), the **Debtors** stipulated that the JSNs' liens are "subject and subordinate only" to those prepetition liens that were granted under the Revolver. (PX 76 at 11–12.) But this provision does not subordinate the JSNs' purported lien on the AFI LOC Collateral to AFI (i.e., the lender). So under the Defendants' proposed interpretation of paragraph 5(g), the JSNs' purported liens on the AFI LOC Collateral would be elevated ahead of the AFI's liens in that same collateral. Additionally, while granting the JSNs a postpetition adequate protection lien on the Revolver Collateral and the *574 AFI LOC Collateral, the Cash Collateral Order subordinated those liens to any existing liens on the same collateral. To that end, with respect to the JSNs' adequate protection lien on the Revolver Collateral the Order acknowledges that the lien is junior to the "existing liens granted to the Junior Secured Parties." (*Id.* at 28.) With respect to AFI LOC Collateral, though, the Cash Collateral Order does not mention the JSNs' purported existing lien on that collateral. (*Id.* at 28–29.)

Other documents also indicate that paragraph 5(g) was not intended to revive any previously released JSN liens. For example, in the JSN PSA, the JSNs expressly reserved the right to make a claim for an equitable lien on the AFI LOC Collateral. (PX 252 § 5.6.) That would have been superfluous if the JSNs believed that paragraph 5(g) already granted them a lien on that collateral. Moreover, when the **Debtors** sought approval of the Barclays DIP Facility, they argued that any asserted equitable JSN lien on the AFI LOC Collateral was invalid and not perfected. (PX 88 at 55.) That position would have been inconsistent with a stipulation granting the JSNs a lien on that collateral in paragraph 5(g). Neither the motion for approval of the use of cash collateral, nor any disclosures to the Court in connection with the interim or final cash collateral orders, disclose that the JSNs believed they were getting a perfected security interest in any previously released collateral.

F. The Asset Sales

On the Petition Date, the **Debtors** filed motions to approve stalking horse bids from AFI and Nationstar with respect to the **Debtors'** Whole Loan Portfolio and Servicing and Origination Assets, respectively. (*See* PX 61.) The **Debtors** entered into the initial stalking-horse bid with Nationstar to sell the servicing, origination, and capital markets platforms (which included people, software, and IT) of the **Debtors**. (PX 33.) The **Debtors** also agreed to sell Nationstar contracts, servicing agreements, MSRs

owned by the **Debtors**, certain Ginnie Mae-guaranteed whole loans, and intellectual property, goodwill, and general intangibles “Related to the Business” for \$2.3 billion. (*Id.* at 38–41.)

After the Petition Date, on June 15, 2012, Berkshire Hathaway, Inc. (“Berkshire”) submitted competing bids to become the stalking horse bidder for both sets of assets. (Puntus Direct ¶ 59.) The bids, which were submitted without Berkshire having performed any due diligence, were in the form of executed asset purchase agreements virtually identical to the agreements executed by Nationstar (for the Servicing and Origination Assets) and AFI (for the Whole Loan Portfolio). (*Id.*) Due, at least in part, to Berkshire's bids, a “pre-auction” auction (the “Mini Auction”) ensued in advance of and during the sale procedures hearing, with the Court ultimately directing that final proposed stalking horse bids be submitted to the **Debtors** on June 18, 2012. (*Id.*) In accordance with the Court's direction, both Nationstar and Berkshire submitted revised stalking horse bids. (*Id.*) With the support of the Committee, the **Debtors** sought and obtained Court approval of the Nationstar and Berkshire stalking horse bids and the bid and sales procedures at a hearing on June 19, 2012. ²³ (*Id.* ¶ 60.)

In the lead-up to the Asset Sales, the **Debtors** maintained the servicing and origination *575 platforms as going concerns. (Marano Direct ¶¶ 50–51.) The **Debtors** considered, but rejected, the possibility of liquidation, because, according to Mr. Marano, the **Debtors** did not believe that a liquidation was in the best interests of the creditors, and the **Debtors** did “everything [they] could” to prevent a foreclosure. (Oct. 15 Tr. 164:10–25.)

1. The Servicing and Origination Assets Sale

The Court approved the sale and bid procedures with respect to the Servicing and Origination Assets (PX 44), and Centerview approached those institutions that it believed would have an interest in purchasing, and the financial resources and expertise necessary to purchase, the Servicing and Origination Assets, to gauge their respective interest. (Puntus Direct ¶ 61.) Following these initial contacts and an introductory due diligence period for interested parties, the **Debtors'** management team and Centerview made formal presentations to five prospective purchasers, during which they described in detail the Servicing and Origination Assets being sold and afforded them an opportunity to visit the **Debtors'** locations and perform detailed on-site due diligence with the **Debtors'** business units. (*Id.*) The **Debtors** received responses from three potential purchasers: (1) Berkshire, (2) a consortium of two bidders, and (3) a consortium composed of Ocwen and Walter Investment Management Corporation (“Walter”). (*Id.* ¶ 63.) The **Debtors** focused their marketing efforts on these three potential purchasers. (*Id.*)

On October 19, 2012, the **Debtors** received two qualifying bids for the Servicing and Origination Assets: (1) the stalking horse bid previously submitted by Nationstar at a value of \$2.357 billion; and (2) a bid from Ocwen and Walter at a value of \$2.397 billion. (PX 48; PX 47.) The **Debtors** determined that the Ocwen bid was the highest and best bid for the Servicing and Origination Assets and decided that they would open the auction with the Ocwen bid. (Puntus Direct ¶ 64; PTO ¶ 34.) On October 23, 2012, the **Debtors** began the auction for the Servicing and Origination Assets with Ocwen's bid as the opening bid. Two bidders, Nationstar and Ocwen, submitted offers for these assets. Although Ocwen was a bidder of record for these assets, the Ocwen APA provided for the assignment of the **Debtors'** Fannie Mae assets to Walter. (PX 47; Puntus Direct ¶ 69.)

During the auction, the **Debtors** negotiated with Nationstar and Ocwen to obtain certain adjustments to their bids and asset purchase agreements. As required by Ginnie Mae, both bidders agreed to remove the Ginnie Mae liability bifurcation condition in the asset purchase agreements. (Puntus Direct ¶ 71.) Consequently, Ginnie Mae would be able to seek satisfaction of all liabilities relating to Ginnie Mae loans, either pre- or post-closing, related to servicing or origination, from the purchaser of the Servicing and Origination Assets. (*Id.*) Also, although both Ocwen's and Nationstar's bid did not contractually obligate them to acquire the servicing and origination platforms, both bidders agreed to include a commitment to acquire the platforms and associated liabilities as part of the bid. (Puntus Direct ¶ 72; Marano Direct ¶ 62.) To induce Ocwen and Nationstar to make this commitment, the **Debtors** offered the bidders a bid credit in the amount of \$108.4 million, which represented the estimated liabilities associated with the platforms. (PX 56 at 37–41; Puntus Direct ¶ 72.) After 28 rounds of bidding, Ocwen made the highest and best offer to purchase the **Debtors'** Servicing and Origination Assets for itself and Walter, with a winning purchase

price of approximately *576 \$3 billion. (PX 57 at 9–10.) The Court approved the Ocwen Sale on November 19, 2012, and entered an Order approving the asset sales on November 21, 2012. (PX 45; Puntus Direct ¶ 79; PTO ¶ 36.)

The parties **effectuated** the Ocwen Sale through the Ocwen APA, dated as of November 2, 2012 (and as later amended), among Ocwen, ResCap, and certain other **Debtor** signatories. (PX 19; PX 20; PX 21; PX 22; PX 23; PX 24; PTO ¶ 37.) The Ocwen APA provided that Ocwen was buying “goodwill and other intangible assets Related to the Business or related to the Purchased Assets.” (DXPT at 41.) In total, over 2,000 ResCap employees, including those associated with call centers and management, were “migrat[ed]” to Ocwen as part of the purchase of ResCap’s servicing and origination platform with no significant reduction in personnel. (Ziegenfuss Dep. 63:16–19:6, 65:7–21, 67:17–23.)

In the APA, Ocwen attributed zero value to goodwill and intangibles, but in a subsequent 10–Q filing, the company attributed approximately \$210 million to those assets. (DX ZH at 30.) The APA contains a provision that any purchase price allocation in the APA would only bind the parties for tax purposes, and not for any other purpose. (PX 19 at 50.) The parties dispute whether a portion of the purchase price must be allocated to general intangibles and goodwill, as to which the JSNs claim to have a perfected lien.

2. The Whole Loan Portfolio Sale

Contemporaneously with the marketing process for the Servicing and Origination Assets, Centerview considered those institutions that it believed would be interested in and financially capable of purchasing the Whole Loan Portfolio. (Puntus Direct ¶ 65.) Centerview approached those potential purchasers to gauge their respective interest. (*Id.*) On October 19, 2012, the bid deadline approved by the Court, the **Debtors** received two qualifying bids for the Whole Loan Portfolio: (1) the stalking horse bid previously submitted by Berkshire at a value of \$1.324 billion; and (2) a bid from a consortium of four financial bidders led by DLJ Mortgage Capital (the “DLJ Consortium”) at a value of \$1.339 billion. (*Id.* ¶ 66) The **Debtors** determined that the DLJ Consortium bid was the highest and best bid for the Whole Loan Portfolio and decided that they would open the auction with the DLJ Consortium bid. (*Id.*; PTO ¶ 35.)

On October 25, 2012, ResCap held an auction for its Whole Loan Portfolio. (Puntus Direct ¶ 79.) After 11 rounds of bidding, Berkshire won the auction with the highest and best offer of \$1.5 billion, an amount \$175 million higher than the original stalking horse bid. (*Id.*; PX 58 at 22–23.) Before the auction, Berkshire had agreed to continue compliance with certain aspects of the FRB Consent Order and the DOJ/AG Settlement. (Puntus Direct ¶ 79.) The Court approved the Berkshire sale on November 19, 2012, and entered an order approving the asset sales on November 21, 2012. (ECF 12–12020 Doc. # 2247; PX 46.)

G. Facts related to Original Issue Discount

The Junior Secured Notes were issued in connection with a 2008 debt-for-debt exchange offering (the “Exchange”). On May 5, 2008, ResCap issued an Offering Memorandum in which it offered to exchange \$9.537 billion face value amount of its then-outstanding unsecured notes maturing from 2010 through 2015 (the “Old Notes”) for the Junior Secured Notes. (PTO ¶ 7; PX 175.) Under the Exchange, ResCap offered to exchange \$1,000 face principal amount of outstanding unsecured notes for \$800 face value of Junior Secured *577 Notes. (PTO ¶ 8.) Pursuant to a modified Dutch Auction, the clearing price was \$650 per \$1,000 principal amount of Junior Secured Notes, which was the lowest level at which tenders were accepted. (*Id.*) Through the Exchange, ResCap exchanged approximately \$6 billion of Old Notes for approximately \$4 billion in Junior Secured Notes and \$500 million in cash. Approximately 63% of the Old Notes were exchanged in the Exchange. (*Id.* ¶ 9.) The issue price of the Junior Secured Notes was established as \$613.75 based on trading activity from the first day of trading. Using this price, AFI calculated the amount of OID for tax purposes as of the Petition Date to be \$377,262,728. (*Id.* ¶ 52; PX 189; Finnerty Direct ¶ 55.) As an economic matter the Exchange created OID. (Finnerty Direct ¶ 10.) AFI amortized the OID by compounding it on a semi-annual basis. Amortizing OID on a daily compounding basis results in a slightly larger amount of OID: \$386 million. (*Id.* ¶ 60.)

The Plaintiffs argue that the OID should be disallowed in bankruptcy as unmatured interest. The Defendants, on the other hand, argue that the OID should be allowed as part of their claim based on Second Circuit precedent. The Plaintiffs and Defendants each offered expert testimony on issues relating to the bankruptcy treatment of the OID generated in the Exchange. John D. Finnerty, Ph.D., a Managing Director in the Financial Advisory Services Group at AlixPartners, LLP and Professor of Finance at Fordham University's Graduate School of Business Administration, testified on behalf of the Plaintiffs, and Mr. Siegert testified on behalf of the Defendants.

The parties do not dispute that the Exchange was a “fair value” exchange—*i.e.*, that old securities were exchanged for new securities with a reduced principal amount that in theory approximated the market value of the old securities. The Second Circuit's decision  in *LTV Corp. v. Valley Fidelity Bank & Trust Co. (In re Chateaugay Corp.)*, 961 F.2d 378 (2d Cir.1992), addressed the bankruptcy treatment of OID generated in connection with a “face value” exchange—*i.e.*, one in which the principal amount of the debt is not reduced.²⁴ (Finnerty Direct ¶ 102; Oct. 21 Tr. 151:11–14.) The experts also agreed that investors in the Notes were sophisticated investors who understood how to analyze risks associated with investing in OID bonds. (Finnerty Direct ¶ 92; Oct. 21 Tr. 184:8–11.)

In addition, Dr. Finnerty calculated that using semi-annual compounding, \$377 million in OID remained unamortized as of the Petition Date. (Finnerty Direct, App'x 6A.) Dr. Finnerty, though, believed that daily compounding was the more appropriate method, which he calculated to yield \$386 million of unamortized OID as of the Petition Date. (*Id.* at App'x 6B.) Mr. Siegert, on the other hand, testified that he believed that semi-annual compounding *578 was the best method. (*See* Oct. 21 Tr. 163:21–25.)

Dr. Finnerty stressed the economic incentives built into the Exchange: yield, security, and seniority. (Finnerty Direct ¶ 62.) In addition, the Exchange allowed ResCap to reduce its overall debt obligations and extend its debt maturities, thereby enhancing the credit strength of the JSNs' obligor, allowing ResCap to avoid bankruptcy for four more years. (*Id.*) In fact, the JSNs will achieve a greater recovery than the noteholders who did not exchange and whose notes remained outstanding on the Petition Date. The **Debtors** Disclosure Statement (ECF 12–12020 Doc. # 4811) indicates that while the hold-outs have retained a \$1,000 par amount unsecured claim, they are projected to recover only 36.3%, or \$363.00. (Finnerty Direct ¶ 88.) In contrast, the holders of the JSNs, who received \$800 of new secured notes in June 2008, are projected to recover \$840. (*Id.*) The Exchange was attractive—and future exchanges could likewise be attractive regardless of the bankruptcy treatment of OID—because of the competitive effective yield of the Junior Secured Notes at issuance, the fact that the Junior Secured Notes, unlike the Old Notes, were secured, and the fact that the Junior Secured Notes were structurally senior to the Old Notes. (*Id.* ¶¶ 62–67, 93.)

Mr. Siegert, in contrast, testified, among other things, that: (1) the disclosures made by ResCap in the Exchange, along with general market evidence, are inconsistent with the conclusion that the Exchange generated disallowable OID for bankruptcy purposes; and (2) disallowing OID in fair value exchanges such as the Exchange would likely cause debt-holders to either reject such exchanges or demand more from distressed companies, thereby discouraging out-of-court workouts and leading to a greater number of bankruptcies. (Siegert Direct ¶ 30.) Mr. Siegert noted that the disclosures did not warn that the Exchange could create OID that would be disallowed in bankruptcy. (*Id.* ¶ 31.) Mr. Siegert also testified that the market did not place much value on the structural enhancements to the Notes that the Exchange created since 63% of noteholders participated in the Exchange, which was a lower participation rate than typical debt-for-debt exchanges. (*Id.* ¶ 32.) ResCap was expecting a significantly higher level of participation in the Exchange; the company and its advisors originally projected a base case participation level of 76%. (*See* Hall Dep. 53:10–21.)

If ResCap had not executed the Exchange, the Company would not have had an ability to meet its debt service obligations as they came due without some third party intervention. (Hall Dep. 43:10–16.) The successful completion of the Exchange enhanced shareholder value by reducing the amount of the Company's outstanding debt. (Hall Dep. 55:14–23; Oct. 21 Tr. 64:5–8; 64:25–65:2.) The successful completion of the Exchange also provided ResCap, its creditors, and other stakeholders with several other valuable benefits, including reducing ResCap's debt service and extending the maturities on ResCap's outstanding debt. (DX BB at 13; Oct. 21 Tr. 18:10–14; 63:6–15; 64:5–8.)

Both experts testified that there is little difference between a face value exchange and a fair value exchange, making disparate treatment for the two exchanges in bankruptcy economically illogical. (Siegert Direct ¶ 37; Oct. 21 Tr. 67:10–69:9.) Mr. Siegert explained that both fair and face value exchanges offer companies the opportunity to restructure out-of-court, avoiding the time and costs—both direct *579 and indirect—of a bankruptcy proceeding. (DX AIJ at 7.)

The Second Circuit treats OID created by face value exchanges as allowable in bankruptcy, despite the Code's provision that unmatured interest is disallowed. See [Chateaugay](#), 961 F.2d at 384. The [Chateaugay](#) decision left open the possibility that fair value exchanges could be treated differently, but it did not resolve the issue. Both Dr. Finnerty and Mr. Siegert acknowledged that under [Chateaugay](#), there would be no disallowable OID here if the Junior Secured Notes were issued at 100% face value, and all other inducements for participation remained the same. (Oct. 21 Tr. 136:9–20; 214:2–4.) Dr. Finnerty and Mr. Siegert also both acknowledged that if creditors knew that OID created in fair value exchanges would be disallowed, distressed issuers would need to offer greater incentives to participate. (Siegert Direct ¶ 3 8; DX ABC; Oct. 21 Tr. 101:15–17.) According to Mr. Siegert, this would make distressed debt exchanges more difficult and would likely lead to more bankruptcy filings as opposed to out-of-court workouts. Additionally, bondholders could simply reject fair value exchanges altogether. (Siegert Direct ¶ 3 8.) The experts also both testified that they are unaware of any other creditors whose claim would be determined in bankruptcy based on the trading prices of bonds used to determine the issue price. (DX AIJ 10; Oct. 21 Tr. 23:20–24:2.) Thus, a holder of the Old Notes would not know the amount of OID that would be disallowed in bankruptcy before tendering. (Oct. 21 Tr. 50:24–51:21.) The legal analysis of OID is found in section III.A below.

H. The Paydowns

On or about June 13, 2013, the **Debtors** made a payment in the amount of \$800 million on account of the outstanding principal of the Junior Secured Notes. (See ECF Doc. # 3967.) On or about July 30, 2013, the **Debtors** made an additional \$300 million payment on account of the outstanding principal of the Junior Secured Notes. (See ECF Doc. # 4404.) Together these repayments reduced the outstanding principal balance by \$1.1 billion.

I. Expert Valuations of JSN Collateral on Petition Date

The JSNs offered valuation testimony from four proposed experts affiliated with Houlihan: Messrs. Fazio, Levine, Taylor, and Siegert. Mr. Fazio offered opinions on the Petition Date value of the **Debtors'** sold and unsold HFS assets and certain other unsold assets. (Fazio Direct ¶¶ 2–3; Oct. 22 Tr. 122:10–13.) He also offered an opinion on the Petition Date value of a hypothetical entity consisting solely of the **Debtors'** MSRs, servicing operations, and originations platform. (Fazio Direct ¶¶ 2, 7; Oct. 22 Tr. 122:14–16.) Mr. Levine offered opinions on the Petition Date value of the **Debtors'** MSRs, refinancing opportunities associated with the MSRs, and Servicing Advances. (Levine Direct ¶ 2.) Mr. Taylor offered an opinion on the allocation of value to certain assets associated with the Ocwen asset sale, including intangible assets, goodwill, and liabilities acquired by Ocwen and Walter. (Taylor Direct ¶¶ 2–3, 7.)

Mr. Siegert offered a single “Global Summary” of these Houlihan opinions suggesting the net fair market value of the JSN Collateral on the Petition Date totaled \$2.79 billion. (Siegert Direct ¶¶ 4, 25; Oct. 23 Tr. 134:1–14, 141:14–142:6; DX ABF at 10.) He arrived at this value by first summing (1) the valuations of the **Debtors'** cash, HFS assets, unsold servicing advances, FHA/VA loans, equity interests, hedge contracts, and certain other contracts; (2) the valuation of the **Debtors'** *580 sold servicing advances; and (3) his own valuation of the **Debtors'** intangible assets, derived from his own analysis of Messrs. Fazio, Taylor, and Levine's valuations. (DX ABF at 9–10.) This totaled \$4.450 billion. (*Id.* at 10.) Mr. Siegert then subtracted \$747 million owed to Ally on the Ally Revolver, and \$912 million owed on two facilities,²⁵ to reach \$2.791 billion. (Siegert Direct ¶ 25 & n. 6; DX ABF at 10.)

The Houlihan experts' valuation assumes that the assets could have been sold on the Petition Date by the **Debtors**. (Oct. 22 Tr. 139:18–142:4; Oct. 23 Tr. 147:23–149:3, 149:18–22.) But when valuing the assets, the Defendants' experts did not look to

sales conducted by other distressed entities on the brink of insolvency; rather, the experts treated ResCap as a solvent seller able to capture fair value for its assets.

The Plaintiffs, on the other hand, offered the opinion of Mr. Puntus, Partner and Co-Head of the Restructuring Group at Centerview. Mr. Puntus has been the lead investment banker for the **Debtors** for over two years. (Puntus Direct ¶ 1, 16; Oct. 16 Tr. 98:9–16.) He was heavily involved in the **Debtors** decision to market their assets, the prepetition marketing process and the postpetition sale process, serving as the lead business negotiator for the **Debtors** on the stalking horse agreements as well as the auction process. (Oct. 16 Tr. 97:23–98:16, 103:6–9.)

Mr. Puntus used the initial Nationstar and AFI stalking horse agreements to determine the benchmark value in his analysis (\$1.736 billion), even though these agreements were never consummated. He also endeavored to estimate what the JSNs' Collateral would have been worth upon foreclosure, where the disposition of the assets would have been controlled, in the first instance, by the First Priority Collateral Agent (directed by AFI) or the lenders (*i.e.*, Barclays and AFI for GSAP and BMZ, respectively).

Mr. Puntus's benchmark did not represent his opinion of the value of the JSNs' Collateral for purposes of adequate protection because the purchase prices reflected in the stalking horse deals were contingent upon the continued operation of the **Debtors** business in **chapter 11** (Oct. 16 Tr. 103:10–22.) To estimate the value of the JSNs' Collateral as of the Petition Date in the hands of the creditors' agents upon foreclosure, Mr. Puntus therefore made certain downward adjustments from his benchmark valuation. Mr. Puntus based these adjustments on two alternative scenarios, differing in how long he assumed the creditors would take to dispose of the collateral: “Alternative A” assumed the collateral would be monetized by the collateral agents over a three to four month time period (\$1.474 billion), while “Alternative B” assumed a five to six-month period (\$1.594 billion). (Puntus Direct, ¶¶ 86–88.) Mr. Puntus further made reductions to account for RMBS and government set off risks, which reduced the “Alternative A” valuation to \$1.046 billion, and the “Alternative B” valuation to \$1.135 billion. (Puntus Direct Ex. 1 at 9.)

Mr. Puntus's methodology was dependent upon his subjective valuations of risks associated with the collateral. At trial, Mr. Puntus conceded that he had never seen a valuation analysis relying on similar methodology before. (Oct. 16 Tr. 36:6–8.) Nor is it likely that Mr. Puntus's valuation methodology could be used in other contexts. *581 While Mr. Puntus's methodology is unsupportable, the numbers he reached may well be closer to the actual value of the JSN Collateral on the Petition Date.

J. Effective Date Value of JSN Collateral

The parties agree to a value of \$1.88 billion as the baseline valuation for the JSNs' collateral as of December 15, 2013 (the assumed “Effective Date”), but the **Debtors** contend that only \$1.75 billion of that collateral is properly distributable to the JSNs. The Plaintiffs seek to reduce the JSNs' potential recovery by assessing \$143 million of expenses under the Carve Out against the JSN Collateral. The Plaintiffs argue that the Cash Collateral Order expressly made the JSNs' liens subordinate to the Carve Out. The Defendants countered that the Plaintiffs should use unencumbered cash to pay the Carve Out rather than JSN cash collateral.

1. Deposit Accounts

Except for the Controlled Accounts (defined below), the Deposit Accounts listed on Schedule 5 to the Committee Action are not subject to an executed control agreement among the relevant **Debtor**, the Third Priority Collateral Agent, and the bank where such Deposit Accounts are maintained. (PX 126; Landy Direct ¶¶ 3(d), 24(a), 40.) The uncontroverted evidence at trial established that, as of the Petition Date, the Deposit Accounts held funds in the amount of \$48,502,829. (Landy Direct ¶ 41.)

Executed control agreements were admitted into evidence for the following Deposit Accounts (collectively, the “Controlled Accounts”): Account Nos. xxxx7570, xxx6190, xxx8567, xxxx7618, xxxx2763, and xxxx0593. (*See* DX AIU; DX AIV; DX

AIW; DX AIX; DX AIY; DX AIZ.) As of the Petition Date, the Controlled Accounts held an aggregate amount of \$16,885. (PX 126.) Deposit Account Nos. xxxx2607, xxxx7877, and xxxx1176 (collectively, the “WF Accounts”) are maintained at Wells Fargo, which is the Third Priority Collateral Agent. The WF Accounts contained \$38,321 as of the Petition Date. (PX 126.)

Deposit Account Nos. xxxx3803 and xxxx6323 (together, the “Ally Accounts”) are maintained at Ally Bank, which is an indirect, wholly-owned subsidiary of the AFI, the Revolver Lender. (PTO JSN Contentions ¶ 103.) Ally Bank is not a party to the Junior Notes Documents, the Revolver Documents or the Intercreditor Agreement and is therefore not a “secured party” within the meaning of the U.C.C. for purposes of control and perfection. Further, the Third Priority Secured Parties are not perfected by virtue of the Revolver Lender and Ally Bank being affiliates. First, given that they are not the same entity, the Revolver Lender's lien is not perfected under the U.C.C. through automatic control. Second, even if AFI's lien were perfected through automatic control, that would be the case only with respect to its own security interest (under the Revolver).

Deposit Account No. xxxx2599, which is maintained at J.P. Morgan Chase Bank, N.A. and contained \$8,091 as of the Petition Date, contains proceeds of the JSN Collateral (the “Proceeds Account”). (Oct. 17 Tr. 173:4–174:11; PX 6 at 18–19.) The Court finds that the Third Priority Secured Parties have a perfected interest in that account under the U.C.C. because it contains proceeds of JSN Collateral. The Defendants failed to proffer evidence at trial that any of the Deposit Accounts other than the Proceeds Account contain proceeds of the JSN Collateral.

2. Real Property

Various **Debtors** owned the real property and leasehold interests listed on Schedule *582 2 to the Committee Action, and that portion of Schedule 6 to the Committee Action that identifies REO properties (*i.e.*, mortgaged properties acquired through foreclosure or other exercise of remedies under mortgages or deeds of trust that secured the associated mortgage loan instruments) as of the Petition Date. The property and leasehold interests are not subject to either a mortgage or a deed of trust in favor of the Third Priority Collateral Agent (the “Unencumbered Real Property”). (PX 124; PX 127 at 44–47; Landy Direct ¶¶ 3(b), 24(b), 36; Oct. 17 Tr. 175:1–23.) The uncontroverted evidence at trial established that, as of the Petition Date, the fair market value of the Unencumbered Real Property was \$21 million. (Landy Direct ¶ 38.)

The Third Priority Collateral Agent did not know whether it had received any mortgage or deed of trust with respect to the Unencumbered Real Property, nor did it know whether any property owner ever granted or signed a mortgage or deed of trust with respect to the Unencumbered Real Property. (Pinzon Dep. 24:7–11, 29:2–11.) No mortgage or deed of trust for the Unencumbered Real Property was proffered by any party or admitted into evidence during the trial. (Landy Direct ¶ 37.)

The JSNs, therefore, do not have a perfected security interest in or lien on any of the Unencumbered Real Property because that property was not subject to an executed and filed mortgage or deed of trust.

3. Executive Trustee Services, LLC and Equity Investment I, LLC Assets

The Plaintiffs argue that the JSNs do not have liens on assets of Executive Trustee Services, LLC (“ETS”) and Equity Investment I, LLC (“Equity I”). According to the Plaintiffs, ETS pledged all of its assets to the Revolver in February 2011, but did not pledge any assets to the JSNs. The Plaintiffs also claim that any security interest in Equity I was released on December 29, 2009.

On February 16, 2011, ETS executed a joinder to the Revolver Documents and pledged all of its assets to AFI under the Revolver as a guarantor. Neither the **Debtors** nor the JSNs have identified a similar joinder agreement whereby ETS became an obligor under any of the Notes Agreements or granted any security interest to the Noteholders. The JSNs have argued that Section 4.17 of the Notes Indenture and Section 2.3(c) of the Intercreditor Agreement dictate that ETS is a guarantor of the Junior Secured Notes. Section 4.17 of the Notes Indenture provides the process by which future guarantors execute supplemental indentures

guaranteeing the Junior Secured Notes, and Section 2.3(c) of the Intercreditor Agreement provides that any party pledging assets to the Revolver must also pledge such assets to the JSNs. (PX 1 at 59–60; PX 2 at 17.) But these provisions are not self-effectuating, and ETS was not a party to the Intercreditor Agreement. Absent an indication that ETS actually did pledge assets to the JSNs, the JSNs cannot establish a lien on any ETS assets.

As for Equity I, that entity was an obligor under the Original Revolver Loan Agreement and the Original JSN Security Agreement, but it was removed as an obligor in the amended versions of those agreements. (PX 3; PX 4; PX 5; PX 6; PX 7; PX 8.) Further, On December 29, 2009, the Third Priority Collateral Agent executed a U.C.C.–3 termination statement terminating the security interest in all assets pledged by Equity I. (PX 131 at 841–45.) The next day, the parties executed the amended JSN Security Agreement that removed Equity I as an obligor. (PX 4.) Also on December 30, 2009, Equity I became a guarantor under the AFI LOC. *583 (PX 9.) The JSNs therefore do not have a lien on any Equity I assets.

4. Reacquired Mortgage Loans

Count IV of the Committee's complaint alleges that the JSNs do not have perfected security interests in certain mortgage loans that were (1) released from the JSNs' liens and security interests in May 2010 to be sold to certain Citi and Goldman Repurchase Agreement Facilities ("Repo Facilities"), and (2) subsequently repurchased by the Debtors between September 2010 and the Petition Date (the "Reacquired Mortgage Loans"). As of the Petition Date, the Debtors owned the Reacquired Mortgage Loans, which were coded as "Blanket Lien Collateral" in the CFDR. The Debtors repurchased the majority of the Reacquired Mortgage Loans in January 2012. (See DX ABM, Schedule 1.) The Committee's complaint alleges that the Reacquired Mortgage Loans total approximately \$14 million at book value and \$10 million at fair value. (PX 125; PX 241 at 9.)

Wells Fargo, acting in its capacity as the Third Priority Collateral Agent, filed U.C.C.–3 financing statement amendments in May 2010 terminating the JSNs' security interests in, among other things, loans that later became the Reacquired Mortgage Loans. (See, e.g., PX 133; PX 136.) Those U.C.C.–3 amendments made clear that the assets that were subject to the release were being sold to Repo Facilities by expressly referencing the Repo Facilities and identifying the assets subject to the U.C.C.–3 amendments as the Mortgage Loans listed on certain Schedules to the Repo Facilities. (See, e.g., PX 133; PX 136.) The loans listed on the U.C.C.–3 amendment were within the scope of and were covered by preexisting U.C.C.–1 financing statements. The U.C.C.–3 amendments provided notice of a collateral change, not a termination of the effectiveness of the identified financing statement. (See, e.g., PX 133; PX 136.)

The U.C.C.–1 financing statements, which remained in effect notwithstanding the filing of the U.C.C.–3 financing statements, continued in force and operated to perfect the JSNs' security interests in the Reacquired Mortgage Loans after the Debtors repurchased those loans. (See, e.g., PX 132; PX 4 § 2.) The U.C.C.–1 financing statements and U.C.C.–3 amendments filed by Wells Fargo provided notice to any potential lender seeking to obtain a security interest in the Reacquired Mortgage Loans of the possibility that the JSNs held a perfected security interest therein. Any potential lender inquiring about the collateral (1) could learn that the Reacquired Mortgage Loans had been reacquired by the Debtors subsequent to the filing of the U.C.C.–3 amendments (by virtue of the fact that they were owned by the Debtors); and (2) would have access to the U.C.C.–1 financing statements providing that the JSNs held a perfected security interest in all assets that the Debtors subsequently acquired. (Oct. 23 Tr. 36:5–37:19.)

Had any actual or potential unsecured creditor inquired of ResCap into the status of the Reacquired Mortgage Loans prepetition, that creditor would have learned that the loans were once again subject to AFI's and the JSNs' Blanket Lien, which was reflected in the CFDR. (See Farley Dep. 95:3–14, 110:5–111:14, 115:4–14, 137:21–24, 138:4–11, 176:21–177:3, Oct. 16 Tr. 190:21–192:18; Hall Dep. 117:6–12; Ruhlin Dep. 65:19–22, 66:6–21, 106:8–12, 119:4–9, 155:16–156:2, 156:15–21.)

Therefore, the Court finds that the Reacquired Mortgage Loans are properly treated as collateral for the JSNs at the Petition Date.

***584** 5. *Excluded Assets*

Count I of the Committee's complaint alleges that, pursuant to the JSN Security Agreement, the JSNs do not have perfected security interests in assets that were (1) pledged to a Bilateral Facility (as defined by the JSN Security Agreement) on the date that the Junior Secured Notes were issued by ResCap, (2) subsequently released from the applicable Bilateral Facility prior to May 14, 2012 (the "Petition Date"), and (3) owned by the **Debtors** on the Petition Date and coded as "Blanket Lien Collateral" (the "Former Bilateral Facilities Collateral").²⁶ The Plaintiffs' expert Mr. Landy valued the Former Bilateral Facilities Collateral at \$24 million as of the Petition Date using fair market valuation. (See PX 241 at 9.)

On June 6, 2008, Wells Fargo, acting in its capacity as the Third Priority Collateral Agent, filed [U.C.C.-1](#) financing statements indicating that the JSNs held a security interest in "[a]ll assets [of each grantor] now owned or hereafter acquired and wherever located." (PX 132.) Section 2 of the JSN Security Agreement (the "All-Assets Granting Clause") reaches all of the **Debtors'** assets that are legally and practicably available both at the time, and after, the JSN Security Agreement was executed. (PX 4 at 4–17, 18–19 (providing that the pledge includes assets "whether now or hereafter existing, owned or acquired and wherever located and howsoever created, arising or evidenced").)

The JSN Security Agreement carves out from the JSNs' Collateral certain assets (the "Excluded Assets") that could not be pledged to the JSNs for legal or business reasons. (PX 4 at 15–17 ("provided that, notwithstanding the foregoing, the 'Collateral' described in this Section 2 shall not include Excluded Assets.")) "Excluded Assets" are defined under the JSN Security Agreement as "(c) any asset ... to the extent that the grant of a security interest therein would ... provide any party thereto with a right of termination or default with respect ... to any Bilateral Facility to which such asset is subject as of the Issue Date [(June 6, 2008)]." (PX 4 at 4–15.) The Excluded Assets category included assets pledged to Bilateral Facilities as of the Issue Date, because the terms of the Bilateral Facilities precluded those assets from being pledged to the AFI Revolver or the JSNs. (Oct. 16 Tr. 184:24–185:3.)

The Court previously ruled that the JSN Security Agreement is ambiguous with respect to "whether an Excluded Asset becomes part of the Secured Parties' collateral pursuant to the All-Asset Granting Clause once it ceases to constitute an Excluded Asset." [Residential Capital](#), 495 B.R. at 262. The Court therefore allowed the parties to present extrinsic evidence to determine the parties' intended meaning.

Ms. Farley, the Senior Director of Asset Disposition for ResCap, was involved in negotiating and implementing the Revolver. She testified that she understood that if the Bilateral Facilities had not precluded the **Debtors'** assets pledged thereunder from being pledged to AFI and the JSNs, and if those assets otherwise fell within the broad scope of the Blanket Lien, then the **Debtors** would have included those assets as Revolver and JSN Collateral. (Oct. 16 Tr. 184:24–185:12; Farley Dep. 26:7–18, 58:12–20, 65:13–66:2, 71:5–18.) She also testified that AFI and ResCap understood that the Excluded Assets would change over time. (Oct. 16 Tr. 182:13–21.)

Lara Hall of AFI testified at her deposition that:

- *585** • "AFI's intent was as soon as the assets rolled off the bilateral facility, they would become subject to the blanket lien." (Hall Dep. 123:19–23; *see also id.* 119:7–15);
- at the time the original AFI Revolver and Revolver Security Agreement were negotiated, in exchange for funding the AFI Revolver, AFI was "trying to secure whatever remained unencumbered that we could, that was legally available to be pledged, not an excluded asset and was operationally feasible for the company, being ResCap." (Hall Dep. 106:2–20; 113:2–13); and
- "[t]he blanket lien basically suggested that anytime an asset became uncovered, it would be subject to the blanket lien." (Hall Dep. 116:6–14.)

Joseph Ruhlin, the **Debtors'** former Treasurer, testified that the **Debtors** understood that the Former Bilateral Facilities Collateral “would be covered by the blanket lien as long as they ... were owned [by the **Debtors**] and not pledged elsewhere to another bilateral facility,” and that the **Debtors'** “understanding” was that “once an asset was released from a funding facility, depending on the asset, it would become part of the blanket lien.” (Ruhlin Dep. 89:14–2, 93:8–14, 165:5–9.)

Ms. Farley, in her capacity as the **Debtors'** corporate representative, admitted at her deposition that if a loan was initially excluded from the collateral pool because it was pledged to a Bilateral Facility as of the Issue Date, the loan would be transferred into the pool of Blanket Lien Collateral if and when that Bilateral Facility subsequently terminated. (Farley Dep. 105:17–106:21.) At trial, Ms. Farley testified that, with respect to assets that were Excluded Assets as of June 2008 (because they were pledged under a Bilateral Facility), those assets would become part of the revolver and JSN Collateral pools if they fell within the scope of the security grant when the Bilateral Facility terminated. (Oct. 16 Tr. 186:23–187:9.) Ms. Farley further testified that, in negotiating the terms of the AFI revolver, Ally sought to secure the revolver with as much collateral as possible. (Farley Dep. 45:21–46:4; Farley Direct ¶ 13.)

Additionally, in December 2008, the **Debtors'** outside counsel sent an email explaining that “if at any point while owned by GMAC [] the assets are removed from a Bilateral Facility, the [AFI] Revolver and [JSN] Indenture liens may cover these assets and they will constitute Collateral (if and to the extent Sections 9–406/8 of the U.C.C. are applicable).” (DX ES at 1.)

Given the extrinsic evidence presented at trial about the parties' intent “whether an Excluded Asset becomes part of the Secured Parties' collateral pursuant to the All–Asset Granting Clause once it ceases to constitute an Excluded Asset,” the Court is satisfied that the Former Bilateral Facilities Collateral is properly treated as JSN Collateral at the Petition Date.

III. CONCLUSIONS OF LAW

A. The JSNs Are Entitled to Recover All Original Issue Discount.

[3] The Plaintiffs ask the Court to disallow a portion of the JSNs' claim to the extent the claim seeks recovery of unamortized OID. OID is a form of “deferred interest” created when a bond is issued for less than the face value the borrower contracts to pay at maturity. (Finnerty Direct ¶ 10.) Unlike the more common periodic cash interest “coupon” payments made to noteholders, OID interest accretes over the life of the note but is payable only at maturity. (*Id.*) OID is amortized for tax and accounting purposes over the life of the bond. The Exchange Offer, which was a fair value exchange (*see supra* at *586 II.F), created \$1.549 billion of OID, which amortized over the life of the Junior Secured Notes. (*Id.* at ¶ 11.) As of the Petition Date, unamortized OID on the remaining outstanding Junior Secured Notes was \$386 million.²⁷ (*Id.*)

The JSNs contend that their claim should be allowed in full and should not be reduced by any OID. For the following reasons, the Court agrees that the JSNs' claim should not be reduced by the amount of unamortized OID.

1. In re Chateaugay Controls and Supports Allowing the JSNs' Claim in Full.

 Bankruptcy Code Section 502(b)(2) provides that a creditor's claim should be allowed in full, “except to the extent that ... such claim is for unmatured interest.”  11 U.S.C. § 502(b)(2). The Second Circuit ruled in  *Chateaugay* that unamortized OID is “unmatured interest” within the meaning of  section 502(b)(2).  961 F.2d at 380. Nevertheless, the Second Circuit found that debt-for-debt “face value” exchanges offered as part of a consensual workout do not generate OID that is disallowable as unmatured interest for purposes of  section 502(b)(2).  *Id.* at 383.

The Second Circuit explained that “application ... of OID to exchange offers ... does not make sense if one takes into account the strong bankruptcy policy in favor of the speedy, inexpensive, negotiated resolution of disputes, that is an out-of-court or common law composition.”  *Id.* at 382. The Second Circuit explained further:

If unamortized OID is unallowable in bankruptcy, and if exchanging debt increases the amount of OID, then creditors will be disinclined to cooperate in a consensual workout that might otherwise have rescued a borrower from the precipice of bankruptcy. We must consider the ramifications of a rule that places a creditor in the position of choosing whether to cooperate with a struggling **debtor**, when such cooperation might make the creditor's claims in the event of bankruptcy smaller than they would have been had the creditor refused to cooperate. The bankruptcy court's ruling [excluding OID recovery] places creditors in just such a position, and unreversed would likely result in fewer out-of-court debt exchanges and more **Chapter 11** filings.

 *Id.*

Applying that reasoning, the Second Circuit held “that a face value exchange of debt obligations in a consensual workout does not, for purposes of  [section 502\(b\)\(2\)](#), generate new OID.”  *Id.* Rather than “chang[ing] the character of the underlying debt,” a face value exchange “reaffirms and modifies” the debt.  *Id.* But the court specifically left open whether the same rules should apply to a fair value exchange such as the one in this case. The court stated:

[Disallowing OID recovery] might make sense in the context of a fair market value exchange, where the corporation's overall debt obligations are reduced. In a face value exchange such as LTV's, however, it is unsupportable.

 *Id.*

Here, in ruling on the motions to dismiss, the Court concluded that it would benefit from a fuller evidentiary record before resolving whether as a matter of law the Exchange generated disallowable *587 OID. *Residential Capital*, 495 B.R. at 266. Now having the benefit of a full record and argument, the Court concludes that despite the differences between face value and fair value debt-exchanges, the same rule on disallowance of OID should apply in both circumstances. Since  *Chateaugay* is the law of the Circuit, and holds that unamortized OID should not be disallowed in the case of a face value exchange, the Court concludes that the unamortized OID generated by the fair value exchange here should not be disallowed from the JSNs' claim.

2. The Legislative History of [Section 502\(b\)\(2\)](#)

 [Section 502\(b\)\(2\)](#) was enacted in 1978. The legislative history states that disallowed interest shall include “any portion of prepaid interest that represents an original discounting of the claim [but] would not have been earned on the date of bankruptcy,” and gives as an example: “postpetition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of the bankruptcy.” *H.R.Rep. No. 95-595*, 95th Cong., 1st Sess. 352-54 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6308.

At the time that Congress passed [section 502\(b\)\(2\)](#), debt-for-debt exchanges did not create OID for tax purposes. (See Bankruptcy Reform Act of 1978, [Pub.L. No. 95-598, § 101, 92 Stat. 2549 \(1978\)](#), “The Internal Revenue Code Tax Code”) was first amended in 1990 to provide that both distressed face value exchanges and distressed fair value exchanges create taxable OID. See Omnibus Budget Reconciliation Act of 1990, [Pub.L. No. 101-508, § 11325, 104 Stat. 1388-466 \(1990\)](#). Since that time, both the Second and Fifth Circuits have found that face value exchanges do not create disallowable unmatured interest, notwithstanding that they may create OID under the Tax Code. See [Chateaugay](#), 961 F.2d at 383 (“The tax treatment of a transaction ... need not determine the bankruptcy treatment.... The tax treatment of debt-for-debt exchanges derives from the tax laws' focus on realization events, and suggests that an exchange offer may represent a sensible time to tax the parties. The same reasoning simply does not apply in the bankruptcy context.”); [Texas Commerce Bank, N.A. v. Licht \(In re Pengo Indus., Inc.\)](#), 962 F.2d 543, 550 (5th Cir.1992) (“As bluntly stated by the Second Circuit, the reasoning underlying the tax treatment of debt-for-debt exchanges simply does not apply in the bankruptcy context.”) (internal quotation marks omitted).

The parties do not dispute that disallowable OID is created for bankruptcy purposes when a company issues new debt in an original cash issuance for less than its face value. (Finnerty Direct ¶ 76; Oct. 21 Tr. 155:7–15.) Dr. Finnerty testified that “as an economic matter the bond exchange generated OID,” but Dr. Finnerty never defines “economic matter” beyond references to taxable OID. (*Id.* at ¶ 10.) Under [Chateaugay](#), however, creation of OID for tax purposes is irrelevant in the context of face value exchanges. Because the Court finds no basis for distinguishing OID generated by fair value exchanges from OID generated by face value exchanges, [Chateaugay](#) controls. Even though the Exchange may have generated OID under the Tax Code, that does not dictate that it created disallowable unmatured interest.

3. There is No Reason to Distinguish OID Generated by Fair Value Exchanges from OID Generated by Face Value Exchanges under the Second Circuit's Reasoning in Chateaugay.

As the Second Circuit observed in [Chateaugay](#), an exchange offer made by a *588 financially impaired company “can be either a ‘fair market value exchange’ or a ‘face value exchange.’ ” [961 F.2d at 381](#) (citations omitted).²⁸ Because the Second Circuit in [Chateaugay](#) was presented with a face value exchange, the court did not address whether its decision would extend to a fair value exchange. Instead, the Court explicitly limited its holding to face value exchanges, noting that it “might make sense” to disallow OID in a fair market value exchange. [Id.](#) The Court concludes, having the benefit of a full record and argument, that there is no meaningful basis upon which to distinguish between the two types of exchanges.

The Plaintiffs' expert Dr. Finnerty admitted at trial that distinguishing between face value and fair value exchanges is “somewhat arbitrary.” (Oct. 21 Tr. 67:10–13.) In fact, Dr. Finnerty acknowledged that nearly all of the features that companies consider in connection with a debt-for-debt exchange can be used in both face value and fair value exchanges: (1) granting of security in the issuer's collateral; (2) interest rate; (3) maturity date; (4) payment priorities; (5) affiliate guarantees; (6) other lending covenants; (7) redemption features; (8) adding or removing a sinking fund or conversion feature; and (9) offering stock with the new debt. (*Id.* at 67:17–69:9.) Other than changing the face value of the bond (which is not possible in face value exchanges), an issuer “could adjust every other factor” available to it. (*Id.* at 69:4–9.) For example, an issuer could provide the exchanging noteholders with security. Both experts testified that there would be no disallowable OID if the Junior Secured Notes were issued at \$1,000 face value, even though the new notes were secured while the Old Notes were unsecured, because that exchange would be expressly governed by [Chateaugay](#). (*Id.* at 136:9–20; 214:2–4.) Thus, despite the Plaintiffs' contention that the consideration involved in the Exchange—trading the unsecured notes for secured and structurally senior obligations—justifies

breaking from the Second Circuit's decision in [Chateaugay](#), the evidence presented at trial indicated that the two types of exchanges are virtually identical, and it would be arbitrary for the Court to distinguish between them.

The Court thus concludes that there is no commercial or business reason, or valid theory of corporate finance, to justify treating claims generated by face value and fair value exchanges differently in bankruptcy. First, the market value of the old debt is likely depressed in both a fair value and face value exchange. Second, OID is created for tax purposes in both fair value and face value exchanges. Third, there are concessions and incentives in both fair value and face value exchanges. In addition, both fair and face value exchanges offer companies the opportunity to restructure out-of-court, avoiding the time and costs—both direct and indirect—of a bankruptcy proceeding.

The Plaintiffs argue that the “plain language” of the statute must be enforced unless it leads to an absurd result. They contend that applying the language of [section 502\(b\)](#) to disallow OID will not lead to absurd results because even if OID is disallowed, the JSNs' recovery exceeds the recovery of the still-outstanding Original Noteholders. But the term “unmatured interest” in [section 502\(b\)\(2\)](#) is not defined, making application of the plain language rule debatable. And whatever rules are adopted by courts should provide predictability ^{*589} to parties in [planning](#) transactions. The outcome—whether a transaction results in disallowed OID for bankruptcy purposes—should not hinge on whether, with the benefit of hindsight, noteholders that exchanged their notes did better than those that did not exchange. Determining whether the transaction created disallowable OID should not depend on if the noteholders or the [debtors](#) got a “good deal” in bankruptcy. That rule would create confusion in the market and would likely complicate a financially distressed company's attempts to avoid bankruptcy with the cooperation of its creditors. The reasoning of [Chateaugay](#) supports this conclusion. [961 F.2d at 383](#).

For the foregoing reasons, the Court concludes that the JSNs' claim should not be reduced by the amount of unamortized OID.

B. The JSNs Are Not Entitled to an Adequate Protection Claim.

1. Generally

The Bankruptcy Code requires a [debtor](#) to provide a secured lender with adequate protection against a diminution in value of the secured lender's collateral resulting from: (1) the imposition of the automatic stay under section 362; (2) the use, sale, or lease of the property under section 363; and (3) the granting of a lien under section 364. [11 U.S.C. § 361\(1\)](#). The Bankruptcy Code does not articulate what constitutes “adequate protection” for purposes of the statute, but [section 361](#) articulates three separate examples of what may constitute adequate protection: (1) periodic cash payments; (2) offering a replacement lien “to the extent that such stay, use, sale, lease, or grant results in a decrease in the value of such entity's interest in such property”; and (3) other relief that will assure the creditor that its position will not be adversely affected by the stay. *Id.*; *see also* 3 COLLIER ON BANKRUPTCY ¶¶ 3 62.07[3][b]–[d] (16th ed. 2011).

A secured creditor is entitled to adequate protection of its interest in the value of its collateral and can obtain adequate protection either after a contested cash collateral hearing, or, as is more often the case, by a consensual cash collateral order. At the commencement of this case, the parties negotiated, and the Court signed, a Cash Collateral Order that, among other things, established the JSNs' right to adequate protection for the use of their collateral and the means by which such adequate protection would be provided. Pursuant to paragraph 16 of the Cash Collateral Order, the JSNs are entitled to

[A]dequate protection of their interests in Prepetition Collateral, including Cash Collateral, in an amount equal to the aggregate diminution in value of the Prepetition Collateral to the extent of their interests therein, including any such diminution resulting from the sale, lease or use by the [Debtors](#) (or other

decline in value) of any Prepetition Collateral, including Cash Collateral, the priming of the AFI Lenders' liens on the AFI LOC Collateral by the Carve Out and AFI DIP Loan, and the automatic stay pursuant to [section 362 of the Bankruptcy Code](#)[.]

(PX 76 at 24.) As adequate protection, the JSNs were granted adequate protection liens on all of the collateral securing the AFI Revolver, the AFI LOC, and all of the equity interests of the Barclays DIP Borrowers, and, to the extent that such liens were insufficient to provide adequate protection, the right to assert a claim under [section 507\(b\) of the Bankruptcy Code](#). (*Id.* at 29.) The JSNs now contend they are entitled to recover an adequate protection claim of \$515 million based on alleged diminution in value of their prepetition collateral *590 used during the case under a series of consensual cash collateral orders. The Plaintiffs disagree, asserting that the JSN Collateral has not declined in value since the Petition Date and that the JSNs therefore cannot assert an adequate protection claim.

The parties agree that the amount of any adequate protection claim is to be measured by the difference in value of the collateral on the Petition Date and the Effective Date.²⁹ The parties also largely agree about the Effective Date value of the JSN Collateral, subject to adjustments discussed elsewhere in this Opinion. Thus, much of the testimony offered at trial was aimed at establishing the Petition Date value of the JSNs' collateral.

2. The JSNs Bear the Burden of Showing Diminution in Value.

[4] [5] The burden of proving valuation falls on different parties at different times. In establishing its claim, a secured creditor generally bears the burden under [section 506\(a\)](#) of proving the amount and extent of its lien. [In re Sneijder](#), 407 B.R. 46, 55 (Bankr.S.D.N.Y. 2009); *see also* [In re Heritage Highgate, Inc.](#), 679 F.3d 132, 140 (3d Cir.2012) (holding that “the ultimate burden of persuasion is upon the creditor to demonstrate by a preponderance of the evidence both the extent of its lien and the value of the collateral securing its claim”) (quoting [In re Robertson](#), 135 B.R. 350, 352 (Bankr.E.D.Ark.1992)). Once the amount and extent of the secured claim has been set, the burden shifts to a **debtor** seeking to use, sell, lease, or otherwise encumber the lender's collateral under sections 363 or 364 of the Code to prove that the secured creditor's interest will be adequately protected. *See* [Wilmington Trust Co. v. AMR Corp. \(In re AMR Corp.\)](#), 490 B.R. 470, 477–78 (S.D.N.Y.2013) (holding that the creditor seeking adequate protection “need only establish the validity, [priority, or extent] of its interest in the collateral, while the **Debtor** bears the initial burden of proof as to the issue of adequate protection”) (internal quotation marks and citation omitted); *see also* [Resolution Trust Corp. v. Swedeland Dev. Grp., Inc. \(In re Swedeland Dev. Grp., Inc.\)](#), 16 F.3d 552, 564 (3d Cir.1994) (holding, in the context of granting a priming lien under section 364(d)(1), that the “**debtor** has the burden to establish that the holder of the lien to be subordinated has adequate protection”) (citation omitted). In contrast, a secured creditor seeking to lift the automatic stay under [section 362\(d\)\(1\)](#) “for cause, including lack of adequate protection,” bears the burden of showing that the **debtor** lacks equity in the property. [11 U.S.C. §§ 362\(d\)\(1\), 362\(g\)\(1\)](#); *see also* [In re Elmira Litho, Inc.](#), 174 B.R. 892, 900–03 (Bankr.S.D.N.Y.1994). But in all cases, the creditor bears the burden in the first instance of establishing the amount and extent of its lien under [section 506\(a\)](#).

The JSNs recognize that they must establish their [section 507\(b\)](#) adequate protection claim within the rubric of [section 506\(a\)](#). Further, they concede that the burden of proving the extent of a claim is typically born by the creditor seeking to establish the claim. Nonetheless, the JSNs argue that because their claim seeks adequate protection, the **Debtors** should have the burden of proving that the JSNs' *591 interests were adequately protected. The Court disagrees.

[6] The parties established at the outset of this case that the JSNs' interest in their collateral was adequately protected, when they negotiated, and the Court signed, the Cash Collateral Order.³⁰ As the Court explained in its ruling on the motions to dismiss:

If the value of the JSNs' collateral actually diminishes, then the JSNs may assert an adequate protection claim.... The Defendants caution against establishing new rules on adequate protection and valuation, but the Court's decision is premised on the terms of the Cash Collateral Order, which the JSNs helped negotiate. That Order provided the JSNs with bargained-for adequate protection.

Residential Capital, 497 B.R. at 420. The bargained-for adequate protection included several liens and the right to assert a claim under [section 507\(b\)](#) for any diminution in value not otherwise protected. (PX 76 at 29.) That the JSNs now seek to assert this adequate protection claim based on diminution in value does not shift the initial burden of proving the extent and validity of the claim under [section 506\(a\)](#) to the **Debtors**. Rather, this burden remains squarely with the secured creditor—the JSNs.³¹ See, e.g., *Qmect, Inc. v. Burlingame Capital Partners II, L.P.*, 373 B.R. 682, 690 (N.D.Cal.2007) (affirming bankruptcy court's requirement that secured lenders prove diminution in value of collateral prior to foreclosing on replacement liens, because “the purpose of adequate protection is to protect lenders from diminution in the value of their collateral”).

3. Fair Market Value in the Hands of the **Debtors** is the Proper Petition Date Valuation Methodology.

The Plaintiffs argue that for adequate protection purposes, the collateral should be valued at the Petition Date based on the foreclosure ***592** value of the collateral in the hands of the secured creditor. The Defendants argue that the collateral should be valued based on the fair market value of the collateral in the hands of the **Debtors**. The Court agrees with the Defendants that fair market value rather than foreclosure value applies, but as explained below, this holding provides little benefit to the Defendants because the Defendants' fair market valuation evidence introduced by their expert witnesses is unreliable, vastly overstates the value of the collateral on the Petition Date, and is rejected by the Court as a basis to establish an adequate protection claim.

[7] [8] To establish their entitlement to an adequate protection claim, the JSNs must show that the aggregate value of their collateral diminished from the Petition Date to the Effective Date. The JSNs will only be entitled to adequate protection, if at all, to the extent of the value of their interest in the collateral as of the Petition Date. 11 U.S.C. § 361. The Supreme Court has explained that the phrase “value of such entity's interest” in [section 361](#) means the same as the phrase “value of such creditor's interest” in [section 506\(a\)](#): the value of the collateral. *United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372, 108 S.Ct. 626, 98 L.Ed.2d 740 (1988). Thus, the question becomes how to value the JSN Collateral as of the Petition Date. To answer this question, the Court looks to valuation principles under [section 506\(a\)](#). See *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 74 (1st Cir.1995) (stating that “a valuation for § 361 [i.e. adequate protection] purposes necessarily looks to [§ 506\(a\)](#) for a determination of the amount of a secured claim”).

[Section 506\(a\)](#) provides:

An allowed claim of a creditor secured by a lien on property in which the estate has an interest ... is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property ... and is an unsecured claim to the extent that the value of such creditor's interest ... is less than the amount

of such allowed claim. *Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property....*"

11 U.S.C. § 506(a)(1) (emphasis added).

In *Associates Commercial Corp. v. Rash*, the Supreme Court interpreted section 506(a) in the context of a chapter 13 **plan**, where the chapter 13 **debtor** sought to cram down a **plan** over the objection of a secured creditor, keeping the secured lender's collateral. 520 U.S. 953, 955, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997). In calculating the value of the lender's secured claim, the Court looked at the first sentence of **section 506(a)** and observed that the phrase "value of such creditor's interest" did not explain *how* to value the interest. *Id.* at 960–61, 117 S.Ct. 1879. Therefore, the Court looked to the second sentence of 506(a) and held that "the 'proposed disposition or use' of the collateral is of paramount importance to the valuation question." *Id.* at 962, 117 S.Ct. 1879. Based on the proposed disposition of the property in that case, the Court held that foreclosure value could not be the proper methodology for valuing the secured creditor's claim. *Id.* at 963, 117 S.Ct. 1879. Rather, the Court applied replacement value; the amount a willing buyer would have paid a willing seller for the collateral. *Id.*

Although this case involves the consensual use of collateral in the context of a sale under **chapter 11**, the reasoning of *Rash* is equally applicable here. See *In re Motors Liquidation Co.*, 482 B.R. 485, 492 (Bankr.S.D.N.Y.2012) (holding that "*Rash*'s underlying thought process is still instructive" in calculating value in a 363 sale and further noting that "[p]ost-*Rash* case law suggests that *Rash* can be applied to the provisions of all three reorganization *593 **chapters**—11, 12, and 13—because these chapters all treat secured claims similarly"); see also *Heritage Highgate*, 679 F.3d at 141 (applying *Rash* in **chapter 11** to value secured claim under 506(a)).

The Defendants cite only one case that deals with the exact scenario of this case—diminution of collateral in the context of a consensual use of cash collateral that funded a going concern sale—in which the district court affirmed application of the *Rash* reasoning in the adequate protection context. See *Salzer v. SK Foods, L.P. (In re SK Foods, L.P.)*, 487 B.R. 257, 262 n. 11 (E.D.Cal.2013). In *SK Foods*, secured creditors and the **chapter 11** trustee had negotiated a settlement on the amount of the creditors' adequate protection claim, conducting their valuation based on the proposed disposition of the collateral on the petition date—a going concern sale. *Id.* at 259–60. The bankruptcy court approved the settlement. *Id.* The appellants objected, asserting that the proper valuation could only be liquidation value, setting the value of the secured creditors' adequate protection claim at "0." *Id.* at 260. The district court rejected that argument, holding that "the Bankruptcy Court properly relied upon the 'liquidation' value for those assets which were to be liquidated, and as required by *Rash*, properly relied upon the 'going-concern' value for those assets which were to be sold as part of the business as a going concern." *Id.* at 263.

None of the other cases that the Defendants cite involve the calculation of an adequate protection claim based on diminution in value due to consensual use of collateral. Instead, the cases cited by the Defendants involve valuations performed for forward-looking determinations of whether secured creditors' interests would be adequately protected.³² Nonetheless, *594 the Court views the current valuation exercise as similar in nature. That is, the Court is being asked to apply a Petition Date valuation of the JSN Collateral to determine whether the JSNs' interests as of that date were adequately protected. In doing so, the Court agrees with the holdings of *SK Foods* and the other cases cited by the Defendants that the proper valuation methodology must account for the proposed disposition of the collateral.

The **Debtors** would like this Court to apply a foreclosure standard based on the JSNs' interest in the collateral as of the Petition Date, which, the **Debtors** contend, was simply to be able to foreclose on the property. Thus, because “the purpose of providing adequate protection is to insure that the secured creditor receives the value for which the creditor bargained for prior to the **debtor's** bankruptcy,” *In re WorldCom, Inc.*, 304 B.R. 611, 618–19 (Bankr.S.D.N.Y.2004), the JSNs should be entitled to foreclosure value of the collateral as of the Petition Date—and no more. In support, the **Debtors** cite to a line of cases holding that under a  section 506(a) analysis, a secured lender's interest is limited to the right to foreclose upon the property.³³

The Court disagrees, and in light of the Supreme Court's rulings in  *Rash* and  *Timbers*, the Court finds the cases cited by the Plaintiffs unpersuasive. See  *Winthrop*, 50 F.3d at 75–76 (disapproving of cases that “render[] the second sentence of  § 506(a) virtually meaningless” and holding that “a court remains faithful to the dictates of  § 506(a) by valuing the creditor's interest in the collateral in light of the proposed post-bankruptcy reality: no foreclosure sale and economic benefit for the **debtor** derived from the collateral equal to or greater than its fair market value”). In this case, the parties were not contemplating on the Petition Date that the creditors might conduct a foreclosure sale. The **Debtors** never had any intention of turning over the JSN Collateral to the collateral *595 agent. (Oct. 15 Tr. 164:21–165:2, 249:6–16.) Nor did the JSNs foreclose or attempt to foreclose on the assets. Rather, the JSNs entered into a cash collateral stipulation to allow the sale of assets as a going concern. (DX AIJ at 5.) A going concern valuation is consistent with the **Debtors'** stated purpose in this case as of the Petition Date, which, among other things was “preserv[ing] the **Debtors'** servicing business on a going concern basis for sale.” (PX 137 at 7.) The testimony at trial confirmed that the parties always intended to market and sell the properties as a going concern. This is also evident by looking at the stalking horse APAs that were in place on the Petition Date.³⁴ Thus, in determining the value of the JSN Collateral on the Petition Date, the Court must apply that value based on the proposed disposition of the collateral—fair market value in the hands of the **Debtors**.

4. The JSNs Did Not Calculate the Fair Market Value of the Impaired Collateral in the Hands of an Insolvent Company and Have Therefore Failed to Carry Their Burden of Proving a Diminution in Value.

[9] While the Court agrees with the Defendants that the correct methodology for Petition Date valuation is fair market value in the hands of the **Debtors**, the Court finds that the Defendants have not provided a credible valuation of their collateral as of that date. Therefore, the Defendants have failed to carry their burden of proving a diminution in the value of their collateral, and their adequate protection claim fails.³⁵

As detailed above, the JSNs offered valuation testimony from four experts affiliated with Houlihan. The Houlihan opinions of the fair market value of each asset comprising the JSN Collateral was informed, where applicable, by the prices obtained in the auction process, adjusted for cash flows and loan balances back to the Petition Date. (Siegert Direct ¶ 18.) In addition, Houlihan performed a “bottoms-up” fair market valuation as of the Petition Date. Mr. Siegert offered a single “Global Summary” of the Houlihan opinions suggesting the net fair market value of the JSN Collateral on the Petition Date totaled \$2.79 billion—nearly \$1 billion more than the stipulated Effective Date value of the same collateral. (Siegert Direct ¶¶ 4, 25; Oct. 23 Tr. 134:1–14, 141:14–142:6; DX ABF at 10.) While the Court recognizes that the Houlihan experts used accepted valuation methodologies, the assumptions and inputs they used were seriously flawed. As a result, Houlihan's conclusions regarding value are not credible.

First, the Houlihan experts' valuation assumes that the JSN Collateral could have been sold on the Petition Date by the **Debtors**. (Oct. 22 Tr. 139:18–142:4; Oct. *596 23 Tr. 147:23–149:3, 149:18–22.) This assumption ignores reality. For example, Mr. Levine's opinion assumes a sale with appropriate representations, warranties, and market indemnifications from the seller; he valued the assets assuming that they could be sold free and clear of certain obstacles to sale. (Oct. 22 Tr. 62:17–21.) But at trial, Mr. Levine conceded that a sale of MSRs would have required the consent of the RMBS Trustees and of the GSEs. (*Id.* at 64:8–65:9.) Mr. Levine did not take into account the costs associated with obtaining the requisite consents, and simply assumed that the transaction would have closed upon the receipt of all required consents. (*Id.* at 63:15–25.) Those costs were considerable,

including hundreds of millions of dollars in payments to GSEs to cure alleged liabilities to those entities and obtain their consent to the sale. (*Id.* at 67:1–22; PX 388 ¶ 1.) There was no assurance that the consents could be obtained. In addition, the **Debtors** agreed to settle billions of dollars of potential RMBS liability to obtain consent of the RMBS Trustees and be able sell the assets free and clear. (Marano Direct ¶ 43.) Mr. Levine's valuation did not account for the potential reduction in funds available to the lender or seller in a sale of those assets nor did his valuation take into account the time and difficulty in obtaining those consents. (*Id.* at 72:7–73:10, 69:10–69:20.)

Second, even assuming that the **Debtors** could have sold their assets on the Petition Date—an assumption the Court views with considerable skepticism—the Houlihan valuation suffers from another, fatal flaw. When valuing the assets, the Defendants' experts did not look to sales conducted by other distressed entities on the brink of insolvency. The experts instead only considered a solvent company, able to capture fair value for its assets. Thus, even if the Court accepts that the assets were saleable on the Petition Date—before all of the work conducted during the bankruptcy necessary to make them saleable—the Houlihan experts' valuation cannot be relied upon because it provides a fair market value of the assets in the hands of a solvent company. Most of the assets could not simply be turned over to a buyer who could instantly reap full value as if the assets were commodity products. MSRs require that accurate mortgage security records are provided. The Houlihan valuation ignores the reality of the period leading up to this bankruptcy: ResCap was an insolvent company, over-burdened with debt, owning assets that had to be “fixed” before they could be sold, and facing a real possibility of being shut down. As Mr. Levine testified, the GSEs had the right to terminate ResCap's servicing rights and transfer the rights to another party upon any breach of their servicing agreement. (*Id.* at 96:22–97:7.) Therefore, the Court finds the Houlihan analysis flawed in its premise, and unreliable.

The Court is mindful that the **Debtors** have spent money that belonged to the JSNs. But while the JSNs' cash collateral has been consumed during the case consistent with the Cash Collateral Forecasts, this does not mean that the JSNs have suffered a diminution in the aggregate value of their collateral.³⁶ As already held by the Court, the JSNs are not entitled to an adequate protection claim on a dollar-for-dollar *597 basis for cash collateral used during the case. *Residential Capital*, 497 B.R. at 420. Where cash collateral use is permitted according to an approved budget, and the cash collateral order includes a  [section 506\(c\)](#) waiver, the two provisions work in tandem. Unless the remaining value of the cash and non-cash collateral at the effective date falls below the value of the collateral on the petition date, the creditor is not entitled to compensation for the amount of cash collateral spent under the approved budget. But the **debtor** does not get to charge the secured creditor again for any costs of preserving or enhancing the collateral.

Rather, the Defendants have the burden of showing that there has been a diminution in the aggregate value of JSN Collateral. Case law and the Cash Collateral Order both impose this requirement. The Defendants failed to make this required showing. Simply put, the Court cannot accept that the value of the JSN Collateral on the Effective Date does not exceed the value of their collateral on the Petition Date, even after the expenditure of the JSNs' cash collateral. This result was achieved because the value of the collateral at the Petition Date (even valued in the hands of the **Debtors** on a going concern basis) was very substantially impaired by reason of existing defaults that prevented **Debtors** from disposing of most of their collateral at that time. Through the settlements and consents achieved over many months, with great effort and expense, the **Debtors** successfully closed the sales of most of their assets on very favorable terms. The JSNs and all estate creditors will benefit from this accomplishment.

C. The JSNs Can Establish Whether They Are Oversecured by Aggregating Their Claims against **Debtor** Entities.

[10] Under  [section 506\(b\) of the Bankruptcy Code](#), a secured creditor is *598 entitled to postpetition interest, fees, costs and charges to the extent the value of the property securing the creditor's claim is greater than the amount of the creditor's claim.  [11 U.S.C. § 506\(b\)](#). The **Debtors** contend that under applicable law, the JSNs must be oversecured at a single **Debtor** entity—without reference to JSN Collateral held by other **Debtor** entities—to be entitled to postpetition interest. In contrast, the JSNs argue that a determination of their oversecured status must be made based on the aggregate value of their collateral, across **Debtor** entities. There is a surprising dearth of case law explicitly addressing the issue of valuing the extent of a creditor's security in multi-**debtor** cases. The statute likewise does not provide much guidance. The Court agrees with the JSNs that they

are entitled to aggregate their collateral across **debtor** entities. Any other reading of the statute would lead to inequitable and illogical results.

 **Section 506(b)** permits a secured creditor to collect postpetition interest to the extent that its “allowed secured claim is secured by property the value of which ... is greater than the amount of such claim.”  11 U.S.C. § 506(b).  **Section 506(a)**, in turn, establishes the rule governing the calculation of secured claims. That section provides that a creditor's claim is secured “to the extent of the value of such creditor's interest in the estate's interest in [the securing] property.”  11 U.S.C. § 506(a)(1).

[11] [12] Based on the language of the statute, the Plaintiffs argue that even where a creditor's claim is secured by collateral pledged by other **debtors**, it is necessary to examine the value of a specific “estate's interest” under  **section 506(a)** to determine whether the secured creditor is entitled to postpetition interest with respect to its claim against that particular **debtor** under  **section 506(b)**.³⁷ This view seems to follow from the general principle that, absent **substantive consolidation**, a court will not pool the assets of **multiple debtors** to satisfy their liabilities. See  *Union Sav. Bank v. Augie/Restivo Baking Co. (In re Augie/Restivo Baking Co.)*, 860 F.2d 515, 518 (2d Cir.1988). “Because of the dangers in forcing creditors of one **debtor** to share on a parity with creditors of a less solvent **debtor**, ... **substantive consolidation** ... [is] to ‘be used sparingly.’ ”  *Id.* (quoting  *Chemical Bank New York Trust Co. v. Kheel*, 369 F.2d 845, 847 (2d Cir.1966)) (citation omitted). But aggregating collateral for purposes of determining whether a secured creditor is oversecured and entitled to postpetition interest and fees does not run afoul of this rule. No **debtor** in a multi-**debtor** case will be required to pay a secured creditor more than the value of the secured creditor's collateral. The secured creditor by definition has a superior right to the value of the collateral; junior creditors have no right to share on a parity with the secured creditor.

In support of their interpretation of  **section 506(a)**, the Plaintiffs cite to  *DeNofa v. Nat'l Loan Investors L.P. (In re DeNofa)*, 124 Fed.Appx. 729 (3d Cir.2005). In  *DeNofa*, the Third Circuit addressed whether a secured creditor, secured by both **debtor** and non-**debtor** assets, was entitled to aggregate its collateral to become oversecured.  *Id.* at 730–31. The court held that it was not, stating that “the allowed secured claim of [a secured lender to] examine for purposes of postpetition interest under  § 506(b) is limited to the extent of the value of the property of the [**debtor's**] bankruptcy estate which secures it [under  § 506(a)].”  *Id.* at 731. But  *DeNofa* dealt with **debtor** and non-**debtor** entities; it did not address the situation presented here—**multiple debtor** obligors may own collateral sufficient, in the aggregate, to render a secured creditor oversecured. While the Plaintiffs contend this is a distinction without a difference, the Court disagrees. There is no scenario where a **debtor** will ever have to pay on a secured claim more than the value of the collateral securing the debt. However, when all of the secured lender's obligors are in bankruptcy, to the extent that the aggregate value of the collateral exceeds the lender's claim, the estates' unencumbered assets are unaffected by the payment of postpetition interest, and there is nothing inequitable about permitting the secured lender to apply its collateral towards postpetition interest once its prepetition claim has been paid in full. Therefore,  *DeNofa's* analysis is not dispositive of the questions presented *599 here.³⁸

In another ill-fated attempt to shed light on the issue, the Plaintiffs cite to a Second Circuit case holding that the filing of a joint petition by spouses under **section 302 of the Bankruptcy Code** “does not automatically consolidate their estates,” nor does it “allow the property of one spouse to be used to satisfy the debts of the other spouse.”  *Wornick v. Gaffney*, 544 F.3d 486, 491 (2d Cir.2008). In  *Wornick*, the Second Circuit held that “the trustee may not reach assets in a joint filing that he could not have reached had the spouses filed separately.”  *Id.* The Plaintiffs assert that the same principle should prevail in the context of  **section 506(a)**.

But comparison to [Wornick](#) ignores the important fact that only collateral securing the debt is at stake here; [Wornick](#) is easily distinguishable and of little utility to the Court. The interests at question in [Wornick](#) were the cash surrender values of several life insurance policies. [Id.](#) at 488. The Second Circuit found that under the applicable state insurance law, had the spouses filed separately, neither spouse's creditors could have claimed an interest in the policies' surrender values. [Id.](#) at 489–91 (finding that “the beneficiary has no legal or equitable interest in the policy that could be made part of the property of the beneficiary's bankruptcy estate” and that “the trustee would have been powerless to administer the cash surrender value as part of the estate of the owner/insured because [insurance law] provides an express exemption in favor of the beneficiary”). Under those facts, the court held that “[a] joint filing does not vest the trustee with the power to reach a spouse's assets that would have otherwise been insulated....” [Id.](#) at 491. The facts in front of this Court are completely different. The JSNs do have a right to assert claims against property held at each of the individual **Debtors**. Thus, the question presented here does not involve property that does not form part of the secured creditor's collateral; only collateral pledged to the secured creditor will be used to pay postpetition interest. Rather, the question is whether property subject to the JSNs' liens, held across **multiple debtors**, can be aggregated for the purposes of making the JSNs oversecured.

The Defendants cite two cases explicitly rejecting arguments that a secured creditor had to be oversecured at a single **debtor** in order to be entitled to postpetition interest.³⁹ See [*600 In re SW Hotel Venture, LLC](#), 460 B.R. 4, 26 (Bankr.D.Mass.2011), *aff'd in part and rev'd on other grounds sub nom.* [Prudential Ins. Co. of Am. v. City of Boston \(In re SW Boston Hotel Venture, LLC\)](#), 479 B.R. 210 (1st Cir. BAP 2012); *In re Revolution Dairy, LLC*, Case No. 13–20770 (Bankr.D.Utah Apr. 29, 2013) Hr'g Tr. [Docket No. 206] (the “Rev. Dairy Tr.”). In [SW Hotel Venture](#), the **debtors**, like the Plaintiffs here, argued that a secured creditor “cannot aggregate the value of all of the **Debtors**' assets to establish an entitlement to postpetition interest.” [460 B.R. at 22](#). The court “unequivocally reject[ed]” this argument, ruling instead that “the determination of [a secured creditor's] status as an oversecured (or undersecured) creditor must be made aggregating the collateral of all the **Debtors**....” [Id.](#) at 33.⁴⁰ In *Revolution Dairy*, the court reached the same conclusion. There, affiliated **debtors** argued that the collateral held by each **debtor** should be considered separately for purposes of determining the secured creditors' entitlement to postpetition interest and fees under [section 506\(b\)](#). In rejecting the **debtors**' position, the court noted that the **debtors**' failure to “cite ... case authority in support of their argument” was “not surprising,” as “[t]he argument is clearly inconsistent with the code and cannot stand modest scrutiny.” *Revolution Dairy*, No. 13–20770, Rev. Dairy Tr. at 12:19–13:3.

In this case, given the facts that lead to the creation of the JSNs' liens, the Court believes that the Defendants' interpretation of [section 506](#) best reflects reality and comports with the purpose underlying the Bankruptcy Code. The Plaintiffs argue that adopting the Defendants' suggestion that courts can “cavalierly pool collateral from **multiple debtors**” runs contrary to the plain text of the statute and the principle of law “deeply ingrained” in American corporate and bankruptcy jurisprudence that corporate separateness must be respected absent extraordinary circumstances. See, e.g., [United States v. Bestfoods](#), 524 U.S. 51, 61, 118 S.Ct. 1876, 141 L.Ed.2d 43 (1998) (refusing to disturb corporate separateness to penalize shareholders of polluting company). According to the Plaintiffs, “arbitrarily merging the assets and liabilities of **multiple** distinct entities would upset creditors' expectation that the assets of their **debtor** will be available to satisfy their claim.” (Plaintiffs' Post Trial Brief, ECF Doc. # 186 at 66.) See, e.g., [Augie/Restivo](#), 860 F.2d at 518–19 (“[C]reditors who make loans on the basis of the financial status of a separate entity expect to be able to look to the assets of their particular borrower for satisfaction of that loan.”); [In re Tribune Co.](#), 464 B.R. 126, 182 (Bankr.D.Del.2011) (“In the absence of **substantive consolidation**, entity separateness is fundamental.”).

The Plaintiffs woefully mischaracterize the present situation. Only the value of the JSN Collateral would be used to satisfy their claims. They would have this Court ignore the reality of their business arrangement with the JSNs, in favor of a formulaic

adherence to fictional corporate separateness. Far from “arbitrarily merging” assets of distinct entities, the Court is giving the JSNs the benefit of their bargain. The JSN Indenture explicitly provides that the JSNs are entitled to collect *601 interest until the principal was paid in full. (DX CN at 7; PX 1 at 51.) In the Offering Memorandum, the **Debtors** represented that the JSNs would be secured by ResCap and its subsidiaries, together, jointly and severally. (PX 175 at 1 (“The new notes will be issued by ResCap and will be secured by substantially all of our existing and after-acquired unencumbered assets remaining available to be pledged as collateral as described below. The notes will also be unconditionally guaranteed by subsidiaries of ResCap.”); PX 1. at 79–80.) “Guarantor” is defined in the JSN Indenture as “(i) each of the Subsidiaries of the Company that is a party to this Indenture, and (ii) any other Subsidiary that executes a supplemental indenture in accordance with the provisions of this Indenture.” (PX 1 at 14.) The Guarantors provided unconditional guarantees to the JSNs *jointly and severally*. (*Id.* at 79–80.) Additionally, the JSN Indenture required that if the **Debtors** moved assets to a Significant Subsidiary or created a Significant Subsidiary,⁴¹ such Significant Subsidiary would become a Guarantor, subject to certain exceptions. (*See, e.g., id.* at 59–60 (Section 4.17 requiring all “Significant Subsidiaries” to become “Guarantors” and thus also “Grantors” under the JSN Pledge Agreement).)

Outside of bankruptcy court the JSNs would have been entitled to levy against the assets of any and all of the Obligor and Guarantors to secure their rights to collect interest until principal was paid in full. (*Id.* at 79–80.) The JSN Indenture explicitly states that the JSNs are entitled to collect postpetition interest in the event of a bankruptcy proceeding, to the extent allowed by law. (*Id.* at 51.) The JSN Indenture contains no provision conditioning those interest payments on the JSNs being oversecured at any single **Debtor** entity.

Additionally, the **Debtors** routinely reported their financial status in consolidated financial statements. (*See, e.g.*, DX GU; DX HQ; DX IT; DX JT.) The **Debtors** continued to report collateral value in the aggregate after the Petition Date. (*See, e.g.*, Monthly Operating Report for the Period from September 1, 2012 through September 30, 2012, ECF 12–12020 Doc. # 1914; Monthly Operating Report for the Period from August 1, 2013 through August 31, 2013, ECF 12–12020 Doc. # 5209.)

The Defendants' view more accurately reflects the reality of this case. It also reflects the workings of the business world at large. For example, like the JSN Indenture at issue here, most indentures allow **debtors** to move assets among their subsidiaries, and to create new subsidiaries, as long as the creditors continue to maintain liens in such assets. (See PX 1 § 4.7 (requiring all “Significant Subsidiaries” to become “Guarantors” and thus also “Grantors” under the JSN Pledge Agreement).) This flexibility is beneficial to borrowers, as it enables them to employ varying *602 corporate structures in order to avail themselves of tax benefits, limit their liability, and comply with a **multiplicity** of regulatory requirements (for example, state laws requiring that construction or other permits be obtained by a domestic entity). *See, e.g.*, [In re Owens Corning](#), 419 F.3d 195, 200 (3d Cir.2005) (“[Parent] and its subsidiaries (which include corporations and limited liability companies) comprise a multinational corporate group. Different entities within the group have different purposes. Some, for example, exist to limit liability concerns (such as those related to asbestos), others to gain tax benefits, and others have regulatory reasons for their formation.”). For these **Debtors**, the use of special purpose subsidiaries was particularly necessary in order to allow the **Debtors** to obtain financing secured by mortgage loans. (*See* ECF 12–12020 Doc. # 1546 ¶ 49 (“Presumably to avoid the burden and expense of preparing and recording separate mortgages on each parcel of property, the **Debtors** are permitted to transfer real property to SPVs whose equity were pledged under the Security Agreements.”).)

If, to be oversecured, and thus entitled to payment in full of all amounts owing, including postpetition interest, fees, costs, and charges in a bankruptcy case, secured lenders were required to be oversecured at a single entity, credit agreements and indentures might begin to prohibit corporate families from employing the type of complex subsidiary and affiliate structures that are currently commonplace and borrowers will be required to hold all collateral at a single entity. Lenders might also require their approval before collateral could be moved among entities. Absent these precautions, lenders would be less willing to extend credit (especially to borrowers in precarious economic situations, who may be most in need of financing), or would charge higher interest rates to compensate for the possibility that their contractual rights to postpetition interest, fees, costs, and charges will not be honored in bankruptcy.

Moreover, if the Plaintiffs' view is accepted, [section 506\(b\)](#) will effectively be nullified in multi-**debtor** cases where a secured creditor is not oversecured at any single **debtor**, even in instances where the creditor is vastly oversecured by the property held by the **debtors** in the aggregate. An interpretation of [section 506\(b\)](#) that allows for this scenario defies common sense. For all of these reasons, the Court holds that the JSNs must be allowed to aggregate collateral held at each of the **Debtors** in order to calculate the extent of their security.

D. Since the **Debtors Can Aggregate Collateral, the Court Must Determine What Constitutes JSN Collateral.**

The parties agree to a \$1.88 billion baseline valuation of the JSN Collateral on the Effective Date, but the Defendants want to add to that figure, and the Plaintiffs want to subtract from it. The analysis below addresses both the Defendants' attempts to add to their collateral along with the Plaintiffs' challenges to certain JSN liens on collateral.

1. The JSNs Are Not Entitled to Additional Sale Proceeds for the HFS Collateral.

The Defendants claim that the JSNs' liens attach to an additional \$66 million of cash proceeds from the Berkshire sale, based on their expert's allocation of the sale price to the HFS loans. Mr. Fazio conducted an analysis of the value of the HFS loans sold to Berkshire, reaching a value that was \$66 million higher than that provided by the Plaintiffs. Mr. Fazio testified that he did not rely on the pricing ***603** formula in the Berkshire APA, which broke the HFS loan portfolio into categories based on only one criterion, but instead looked at all the credit quality and credit statistics associated with each of the portfolios to determine value. (Oct. 22 Tr. 167:16–24.) In general, those statistics—including borrower credit rating, interest rate, and delinquency—were better for the JSN loan collateral than for the non-JSN Collateral. (See DX ABI at 5–7.)

The Court does not find Mr. Fazio's calculation the best indicator of the value of the HFS loans. In applying his own methodology to allocate the value of the HFS Portfolio between JSN and non-JSN Collateral, Mr. Fazio disregarded the actual purchase prices that Berkshire Hathaway agreed to pay for the collateral pursuant to § 3.1(a) of the Berkshire APA, which was an arm's-length agreement. ⁴² (PX 31 at 27.) The Berkshire APA classified the loans within the HFS Portfolio into six buckets based on certain characteristics: (1) Performing First Lien; (2) Non-Performing First Lien; (3) Performing Second Lien; (4) Non-Performing Second Lien; (5) Other; and (6) Securitized Advances. (Oct. 22 Tr. 161:20–162:11, 163:7–17; PX 31 at 19.) The Berkshire APA established different purchase prices calculated as percentages to be **multiplied** by the unpaid principal balance of the loans, for each category (plus any adjustments for the document deficiency **multiplier**). (Oct. 22 Tr. 162:12–19; 164:8–166:13; 167:25–168:18; PX 31 at 20.) Rejecting these contractual purchase prices, Mr. Fazio reclassified the loans based on characteristics such as origination vintage, product type, or adjustable or fixed rate mortgage, and valued the loans within his classifications based on metrics such as borrower credit scores and interest rates, to derive his bottoms-up valuation. (Oct. 22 Tr. 154:24–158:11, 159:3–9, 164:1–7, 169:2–10; DX ABI at 5, 19–22.)

[13] Where, as here, an asset is sold in an arm's-length transaction, the fair market value of such asset is conclusively determined by the price paid. See [Romley v. Sun Nat'l Bank \(In re Two "S" Corp.\)](#), 875 F.2d 240, 244 (9th Cir.1989); see also [Covey v. Davlin \(In re Hobbick\)](#), No. 97–83543, 2001 WL 34076375, at *14 (Bankr.C.D.Ill. Sept. 10, 2001). The Berkshire APA was the result of a highly competitive auction process approved by the Court, and the price paid for the whole loans was the result of arm's-length negotiations that established the fair market value of each category of loans. The Court will not rely on Mr. Fazio's reallocation of Berkshire's price calculation. The Court finds that the JSNs are not entitled to a lien on additional sale proceeds for the HFS loans.

2. The JSNs Are Entitled to a \$17 Million Increase in FHA/VA Loan Value.

[14] The Defendants seek to add an additional \$17 million to the baseline collateral, to reflect a net increase to the value of the FHA/VA loans. The difference between the Plaintiffs' and Defendants' valuations of the FHA/VA loans is attributable to their methodologies. The Plaintiffs' expert Mr. Renzi employed a recovery analysis, discounting the figures in the **Debtors'** April 30, 2013 balance sheet for assumed costs of collection. (Oct. 16 Tr. 139:5–11.) Mr. Renzi assumed a recovery rate of 91.1% of book value, deducting the costs, *604 expenses and risks associated with disposing of the assets. (Renzi Direct ¶ 13; Oct. 16 Tr. 144:20–145:2.) The Defendants' expert Mr. Fazio employed a fair market value analysis. Mr. Fazio assumed that the loans would monetize over a 30–36 month period. (DX ABI at 59.) Mr. Fazio discounted the estimated cash flow at 5% over the three year period, taking into consideration the risk of loss and government insurance. (*Id.*) Ultimately, Mr. Fazio valued the FHA/VA loans at 95% of book value. (*Id.*) The Plaintiffs challenge Mr. Fazio's assumption that the loans would be runoff in three years, claiming that the **Debtor** documents on which he relied actually project a seven-year timetable. (Oct. 22 Tr. 169:15–175:8; DX ABI at 58; *see also* Puntus Direct ¶ 162.) Mr. Fazio stated at trial that while his calculations were based on a 100% monetization by the end of the third year, it is possible that some small “insignificant amount” of the loans would not be monetized until years later. (Oct. 22 Tr. 174:22–175:8.)

The Court believes that fair market value, and not recovery value, was the correct methodology for valuing the FHA/VA loans. Even if there are costs in monetizing the loans, the JSNs should not be charged with these costs when valuing the amount of their secured claim pursuant to [section 506\(b\)](#). Under [section 506\(b\)](#), postpetition interest, fees, costs and charges may only be offset by the amounts chargeable to collateral under [section 506\(c\)](#). [11 U.S.C. §§ 506\(b\)–\(c\)](#). Here, there are no such costs under [section 506\(c\)](#) because the **Debtors** waived their [section 506\(c\)](#) rights in the Cash Collateral Order. (PX 76.) Thus, the premise of the Plaintiffs' recovery analysis—that the assets will continue to generate expenses and cost money to monetize—runs counter to [section 506\(b\)](#). The Court finds that the JSNs are entitled to a lien on an additional \$17 million for the FHA/VA loans.

3. The JSNs Are Entitled to Another \$40 Million in Liens on Non-**Debtor** Equity.

[15] The JSNs claim they have a lien on an additional \$40 million of equity interests in non-**Debtor** subsidiaries. Their argument is based on a report filed by the **Debtors**, titled *Periodic Report Regarding Value, Operations and Profitability of Entities in Which the Debtors' Estates Hold a Substantial or Controlling Interest* (the “Periodic Report”), which included a summary balance sheet for each of the non-**Debtor** subsidiaries. (*See* DX ABI at 68–69.) Using the Periodic Report as a guide, Mr. Fazio concluded that the value of the equity pledges in non-**Debtor** Subsidiaries was approximately \$40 million. (*Id.*) Specifically, Mr. Fazio calculated that the value of the equity pledges in the Non-**Debtor** subsidiaries were \$26 million in CAP RE of Vermont, LLC; \$3 million in CMH Holdings LLC; \$1 million in GMAC–RFC Europe Limited; and \$10 million in GMAC–RFC Holdings Limited. (*Id.*)

The Plaintiffs have not offered any evidence regarding these equity interests. At trial, Mr. Renzi testified that Plaintiffs' counsel told him that the non-**Debtor** subsidiaries had very limited equity value due to contingent liabilities, namely litigation liability. (Oct. 16 Tr. 153:16–154:3.) Plaintiffs' counsel further informed Mr. Renzi that the probability was high that the **Debtors** would not prevail in the litigation. (*Id.* at 154:4–9.) Instead of presenting a risk-adjusted equity value to account for the litigation risk at the Non-**Debtor** subsidiaries, based upon his conversations with counsel, Mr. Renzi presented the equity value in those entities as zero. (*Id.* at 153:12–154:15.)

Moreover, the Plaintiffs have not refuted that the JSNs have a lien on equity pledges. The Defendants have carried *605 their initial burden of putting forth evidence to show they have an interest in the equity of these non-**Debtor** subsidiaries, in an amount totaling \$40 million. The Plaintiffs' expert did not produce a value for the equity; Mr. Renzi simply valued the equity at “0.”

The Plaintiffs have therefore failed to put forth sufficient evidence to rebut the Defendants' claim. *See* [Heritage Highgate, 679 F.3d at 140](#) (“It is only fair ... that the party seeking to negate the presumptively valid amount of a secured claim—and

thereby affect the rights of a creditor—bear the initial burden.... If the movant establishes with sufficient evidence that the proof of claim overvalues a creditor's secured claim because the collateral is of insufficient value, the burden shifts.”). The Court finds that the JSNs have a lien on \$40 million of equity at non-Debtor entities.

4. The JSNs Do Not Have a Lien on Any Collateral Pledged to the AFI LOC.

The Defendants offer two arguments for why the JSNs have liens on approximately \$910 million in collateral pledged to the AFI LOC. First, the Defendants claim that the collateral was previously pledged to the JSNs and was never properly released from the JSNs' liens, so their liens still attach to the collateral. Second, the Defendants assert that even if their liens on the collateral were released, paragraph 5(g) of the Cash Collateral Order revived those liens. Both arguments fail.

a. All JSN Collateral Subsequently Pledged to the AFI LOC Was Properly Released Before Being Pledged to the AFI LOC.

In 2010 and 2011, Wells Fargo, acting as Third Priority Collateral Agent (i.e., the collateral agent for the Junior Secured Notes) consented in writing to the release of a variety of assets from the Notes Collateral that were then pledged to AFI under the LOC Facility. Wells Fargo did this by executing the Blanket Loan Release, which released the JSNs' security interest in the Released Loan Collateral, and the Servicing Advance Release, which released the JSNs' security interest in the Released Advances. Wells Fargo then filed U.C.C.–3 amendments that deleted the Blanket Released Collateral from the collateral provided in the original U.C.C.–1 financing statements (as amended) filed by the Third Priority Collateral Agent.

The Defendants previously contested the effectiveness of those releases. The Court rejected the Defendants' arguments, holding that the releases were effective and entitled to enforcement. *See Residential Capital*, 497 B.R. at 416–17. Specifically reviewing the Blanket Loan Release—which accounts for approximately 97% of the \$910 million in dispute—the Court found that the descriptions of the collateral covered by that release satisfied U.C.C. 9–108(b)'s requirement for reasonably identifying the released collateral, and the U.C.C.–3s “are therefore valid.” *Id.* at 418.

At trial, the Defendants tried to attack the releases of the collateral pledged to the AFI LOC by arguing that there was an insufficient paper trail documenting the releases. This is not so. The Blanket Loan Release released, among other things, “Servicing Rights Collateral” and “Subject Mortgage Loans.” The releases provided three means for determining whether an asset was a Subject Mortgage Loan that had been released from the Revolver and Junior Secured Notes:

- a “Mortgage Schedule delivered under the LOC Loan Agreement”;
- in the backup to the monthly borrowing base reports or monthly collateral reports under the LOC Loan Agreement, which reflected the carrying value *606 of the assets pledged to the LOC Facility; or
- most broadly, any of the Debtors' “books and records” reflecting that a loan had been pledged to the LOC Facility. This category would include, among other things, the CFDR, which tracked various details concerning the Debtors' loans, including the facility (if any) to which such loans were pledged.

(PX 134.)

Under these terms, if a loan was listed on the CFDR as pledged to the AFI LOC, it was covered by the Blanket Loan Release. There is no dispute that the collateral in question was listed in the CFDR as pledged to the AFI LOC. The Court has already admitted the CFDR as a reliable record that was subject to rigorous audits and controls. Therefore, the releases were effective since the loans appeared in the CFDR as pledged to the AFI LOC. Moreover, a written description of the released collateral was attached as an exhibit to the U.C.C.–3 amendments, which the Third Priority Collateral Agent also filed to delete the Blanket Released Collateral from the collateral set forth in the original U.C.C.–1 financing statements. These written descriptions put

all potential creditors on notice that the collateral they covered includes certain servicing rights and mortgage loans (among other assets), and that further diligence may be required to determine to whom they are pledged. As the Court has explained, the U.C.C.–3s are sufficient to satisfy the lenient description standards outlined in [U.C.C. § 9–108\(b\)\(6\)](#) because the descriptions of the collateral released “reasonably identif[ied]” the collateral released, satisfying the U.C.C. permissive standard. See *Residential Capital*, 497 B.R. at 418.

The Court's conclusion applies with equal force to the Servicing Advance Release. Like the Blanket Loan Release, the Servicing Advance Release contained a description of various categories of Released Advances that were being released from the JSNs' liens, which included, among others, any existing and future advances relating to mortgage loans and REO property, made pursuant to certain contracts with Freddie Mac. Moreover, the Servicing Advance Release described all servicing advances pledged to the AFI LOC.

The Defendants contend that other back-up documentation should exist regarding the release of this \$910 million of assets, including schedules of mortgage loans, collateral addition notices to the LOC Facility, and electronic templates used to update the CFDR. But there is no need for this type of additional back-up. The CFDR suffices for the Blanket Loan Release, and the Servicing Advance Release effectively released all advances pledged to the AFI LOC.

b. Paragraph 5(g) Did Not Revive Any Liens on Collateral Pledged
to the AFI LOC or to Any Other Previously Released Collateral.

[16] The Defendants ask the Court to interpret paragraph 5(g) of the Cash Collateral Order to mean that the **Debtors** agreed that assets released from the JSNs' liens years earlier were revived by the Order. If so, the Defendants would have a lien on the collateral pledged to the AFI LOC, totaling an additional \$1.1 billion in value. In ruling on the motions to dismiss, the Court determined that it would benefit from a greater factual record on this issue, and extrinsic evidence could be submitted to establish the meaning of paragraph 5(g). *Residential Capital*, 497 B.R. at 403. Based on the evidence submitted by both sides, the Court concludes that the Defendants' interpretation of paragraph 5(g) fails on **multiple** grounds.

First, the Court notes that no party ever disclosed this purported effect of paragraph ~~5~~⁶⁰⁷ 5(g) to the Court when the Cash Collateral Order was proposed or at any contemporaneous hearing, despite Local Rule 4001–2(a)(6). That rule requires disclosure of provisions in a cash collateral motion that would secure prepetition debt with liens on assets that the creditor would not otherwise have by virtue of the prepetition security agreement or applicable law. The Court will not countenance the Defendants' attempt to slide a \$1.2 billion windfall past the Court and past the Plaintiffs.

Second, other portions of the Cash Collateral Order reveal the parties' intent at the time the order was submitted. For instance, the very next stipulation in the Cash Collateral Order provides an overview of the collateral securing the Junior Secured Notes:

[T]he collateral securing the Junior Secured Notes Obligations includes, among others ... the categories of assets under the columns labeled “Ally Revolver” and “Blanket” set forth on Exhibit A to this Final Order....

(PX 76 at 12.) If, at the time the Cash Collateral Order was negotiated, the JSNs actually believed that they were being granted new liens on the AFI LOC collateral, paragraph 5(h) should have included “AFI LOC” in the categories of assets securing the Junior Secured Notes on Exhibit A to the Cash Collateral Order.

Moreover, the Defendants' reading of Paragraph 5(g) is also not supported by the language of the Cash Collateral Order. For example, in Paragraph 5(g), the **Debtors** acknowledge that the JSNs' liens are "subject and subordinate *only*" to the liens granted under the Revolver. (*Id.* at 11–12 (emphasis added).) This provision does not also subordinate JSNs' purported lien to the LOC Lenders' lien under the LOC Facility. Under the Defendants' proposed interpretation of Paragraph 5(g), the JSNs' purportedly revived lien on the AFI LOC collateral is elevated ahead of the LOC Lenders' (uncontrovertibly senior) lien in that collateral. AFI would not have agreed to such a provision, especially since it relied on the AFI LOC collateral to make the postpetition advances under the Cash Collateral Order.

In addition, in granting the JSNs a postpetition adequate protection lien on the Revolver Collateral and the AFI LOC collateral, the Cash Collateral Order subordinated adequate protection liens to any *existing* liens on the same collateral. To that end, with respect to the JSNs' adequate protection lien on the Revolver Collateral, the order acknowledges that the adequate protection lien is junior to (among other things) the "*existing liens granted to the Junior Secured Parties.*" (*Id.* at 28 (emphasis added).) But the order does not contain similar language with respect to the adequate protection lien in the AFI LOC collateral, indicating that the JSNs did not have an existing lien on that collateral. (*Id.* at 28–29.)

Aside from the terms of the Cash Collateral Order, other documents filed simultaneously in the bankruptcy court reflect that the stipulations in paragraph 5(g) were not intended to revive previously released liens. For example, the **Debtors** indicated in their motion seeking approval of the Barclays DIP Facility that any purported equitable lien asserted by the JSNs on the assets securing the AFI LOC was not a valid, perfected, and nonavoidable lien or security interest as of the Petition Date. (PX 88 at 55.) Offering that argument is squarely at odds with a purported stipulation to the validity of a lien on that collateral.

Third, the testimony of Mr. Siegert indicates that when the parties were negotiating the Cash Collateral Order, the JSNs did not believe that the Order would revive liens on more than \$1 billion in released ***608** collateral. The JSNs did not include the value of the assets securing the AFI LOC in their own contemporaneous analysis of the collateral securing the Junior Secured Notes. On cross-examination, Mr. Siegert was shown a Houlihan presentation dated May 14, 2012, which was prepared immediately before the Petition Date. (PX 169; Oct. 23 Tr. 110:8–23.) That presentation valued the JSNs' collateral. Mr. Siegert acknowledged that if the counsel for the JSNs had concluded that the **Debtors** had stipulated to JSN liens on the AFI LOC collateral, that would have been a material fact for Houlihan to consider when presenting estimates of the value of the JSN Collateral. (Oct. 23 Tr. 127:25–128:21.) And further, that would have been a material fact for Houlihan to convey to the JSNs. (*Id.*) But the May 14 Houlihan presentation did not reflect any liens on the AFI LOC collateral. (*Id.*)

It defies the parties' conduct and the terms of the Cash Collateral Order to argue that paragraph 5(g) revived previously leased liens. The JSNs do not have a lien on any AFI LOC collateral by virtue of paragraph 5(g).

5. General Intangibles

The Defendants argue that the value of the JSN Collateral on the Effective Date should increase beyond the \$1.88 baseline valuation because the baseline valuation does not account for certain JSN liens on intangible assets. Specifically, the Defendants argue that the **Debtors** sold intangible assets subject to JSN liens during the Ocwen asset sale, but the **Debtors** did not allocate any portion of the proceeds to intangibles subject to JSN liens. These intangibles include software, certain refinancing opportunities, trademarks, and goodwill. According to the Plaintiffs, Ocwen and Walter did not place any value on these intangibles, so it is not proper to allocate any proceeds to intangible value. Further, the Plaintiffs argue that to the extent the JSNs had any lien on goodwill, that goodwill was created postpetition and is not subject to any JSN lien. The Defendants respond that they had a lien on assets sold to Ocwen, but have received no benefit of the sale simply because the Ocwen APA assigned no value to the intangibles, even though the Ocwen APA provided that Ocwen and Walter were buying "goodwill and other intangible assets." (PX 19.) According to the Defendants, the Court may still assign value to the intangible assets based on the work of the Defendants' expert Mr. Taylor, who used general accounting principles to value the intangible assets.

a. The JSNs Had Liens on Software Sold to Ocwen.

In the JSN Security Agreement, the JSNs were specifically granted a lien on computer software as well as general intangibles. (See PX 4.) The **Debtors** used software in connection with the PLS MSRs and the GSE MSRs. (Oct. 15 Tr. 171:10–12.) The Plaintiffs argue the JSNs' lien on software associated with the PLS MSRs was released under the May 14, 2010 Blanket Release. That release specifically stated that all general intangibles were released “if and to the extent related to the Servicing Rights Collateral” (i.e., the PLS MSRs). (PX 134 at 6.) The Defendants counter, though, that “Servicing Rights Collateral” was defined to specifically exclude computer programs. (*Id.* at 8.) The Court therefore finds that the JSNs' lien on software associated with the PLS MSRs was not released by virtue of the Blanket Release. Any value associated with software sold to Ocwen and Walter would be allocable to the JSNs as JSN Collateral.

The next question is how to value the collateral. The Defendants' expert Mr. Taylor endeavored to value the **Debtors'** ^{*609} software and associated know-how by using an accounting method that considers what a typical market participant would have paid for the asset, regardless of any particular incentives (e.g., synergies) or disincentives that may have existed in the market at the time. The Plaintiffs challenged Mr. Taylor's analysis on several grounds, including that (1) Mr. Taylor's analysis ignores the allocations of assets in the Ocwen APA; (2) the **Debtors** gave Ocwen and Walter a substantial bid credit (exceeding \$100 million) so Ocwen and Walter would buy the **Debtors'** servicing platform, including the software; (3) Ocwen and Walter later attributed lower values to software, ostensibly using the same accounting principles that Mr. Taylor applied; (4) Mr. Taylor's “avoided cost” analysis assumed that Ocwen and Walter **planned** to use the **Debtors'** software for three years, contrary to Ocwen's and Walter's actual **plans**; and (5) Mr. Taylor put inordinate weight on certain precedent transactions when applying his “relief from royalty method.”

First, the Court finds that the allocations in the Ocwen APA do not control here. Section 3.3(b) of that APA provided that the **Debtors** and Ocwen were bound by the allocations for tax purposes, “*but not for any other purpose.*” (PX 19 at 50 (emphasis in original).) Second, the **Debtors'** bid credit awarded to Ocwen did not render the **Debtors'** software valueless. Rather, Ocwen and Walter intended to use and did use the **Debtors'** software associated with the platforms they were buying. Their public filings attributed value to software, whether as a standalone asset or built into the premises and equipment asset category.⁴³ (See DX ZH at 9; DX ST at 3; DX WK at 13.) Therefore, the software had and provided value.

Turning to Mr. Taylor's analysis, the Court is not satisfied with his valuation of the software and associated know-how. The Plaintiffs are correct that Mr. Taylor's avoided cost analysis unreasonably assumes a duration of software use that is contrary to the actual intended use in the Ocwen and Walter sale. As for his “relief from royalty” analysis, the Plaintiffs sufficiently demonstrated flaws in Mr. Taylor's methodology. For example, Mr. Taylor gave no weight to certain transactions between seemingly related parties because those may not have been arm's-length deals. (DX ABH at 135.) But Mr. Taylor then attributed 33.34% of his outcome to a transaction that appears to be between related parties. (*Id.*) Not only is this transaction given greater weight than any other transaction, but it is also a significant outlier in terms of its “point estimate.” (*Id.*) Simply removing Mr. Taylor's weight assigned to this transaction would yield a \$100 million lower software value. Thus, the Court finds that Mr. Taylor's “relief from royalty” analysis is unreliable.

Rather than relying on Mr. Taylor's analysis, the Court turns to how Ocwen and Walter actually reported the value of the software using a fair value accounting method. Walter's public filings indicate a \$17.1 million value for software (DX WK at 13), and Ocwen's filing and its third-party valuation reflect a \$1.295 value for software (DX ZH at 9; DX ST at 3.) The Court therefore finds that \$18.395 million of the Ocwen sale proceeds should be attributed to JSN liens on software.

***610** b. The JSNs Have a Lien on the Tradename, Iconography,
and Logotype Associated With the Assets Sold to Ocwen and Walter.

The Defendants submitted expert evidence that \$10 million of proceeds from the Ocwen and Walter sale was allocable to “tradename/marks, iconography and logotype.” (DX ABH at 42–45.) The Plaintiffs did not rebut this analysis at trial. Mr. Taylor notes that the Ocwen APA required the purchasers to rebrand assets within 120 days, but a 10–Q filed by Walter shows that it attributed value to tradename with an estimated eight-year life. (DX ABH at 43.) Thus, there may have been some intangible tradename or logotype value that would not cease to exist after 120 days. The Plaintiffs did not rebut this contention. Nor did the Plaintiffs demonstrate that any tradename value was associated only with the Servicing Rights Collateral or Subject Mortgage Loans and would therefore have been released in the Blanket Release. The Court is satisfied with Mr. Taylor's valuation of the intangible tradename assets associated with the Ocwen sale and finds that a \$10 million allocation to the JSNs' liens is appropriate.

c. The Defendants Do Not Have a Lien on Refinancing Opportunities Associated With GSE MSRs.

[17] At trial, the Defendants' expert Mr. Levine testified to the value of refinancing opportunities associated with certain GSE MSRs. The JSNs do not have liens on GSE MSRs since those are Excluded Assets, but the Defendants argue that the JSNs have a lien on intangible assets associated with GSE MSRs. Although the Defendants may be correct that the JSNs could have a lien on intangible assets absent a lien on an underlying asset, the value created by refinancing opportunities is inherent to the value of the GSE MSRs. In other words, the opportunities are not a separate intangible asset.

Mr. Levine testified that he regularly values refinancing opportunities separately from servicing rights. (Oct. 22 Tr. 100:9–16.) Even so, the value of the refinancing opportunities are inextricably linked to the MSRs themselves: Mr. Levine conceded that “to the buyer of the servicing, there would not be value to the HARP [refinancing opportunities] without the servicing rights.” (*Id.* at 91:11–23.) In fact, Mr. Levine had never seen an instance where refinancing opportunities were sold separately from servicing rights. (*Id.* at 101:9–11.) Therefore, the value is properly attributable to the GSE MSRs themselves. As such, the JSNs do not have a lien on any refinancing opportunities.

d. The JSNs Did Not Establish the Value of Their Lien on Goodwill as of the Petition Date.

[18] The JSNs argue that they have a lien on goodwill associated with the **Debtors'** assets sold to Ocwen. Goodwill is “an intangible asset that represents the ability of a company to generate earnings over and above the operating value of the company's other tangible and intangible assets.”  *In re Prince*, 85 F.3d 314, 322 (7th Cir.1996). Goodwill may include “name recognition, consumer brand loyalty, or special relationships with suppliers or customers.”  *Id.* To calculate the value of goodwill, generally accepted accounting principles (“GAAP”) look to “any excess of [a] purchase price over the fair value of the assets acquired and the liabilities assumed.”  *Fait v. Regions Fin. Corp.*, 655 F.3d 105, 110 (2d Cir.2011). Although GAAP does not require a company to record internally developed goodwill absent an asset sale, see  *Sanders v. Jackson*, 209 F.3d 998, 1001–02 (7th Cir.2000), the existence of goodwill does not depend on an asset sale. See  *Prince*, 85 F.3d at 323–24 *611 (describing valuation of goodwill in context of assigning value to company stock); see also  *Ackerman v. Schultz (In re Schultz)*, 250 B.R. 22, 29 (Bankr.E.D.N.Y.2000) (valuing goodwill outside context of asset sale). So the question becomes whether any goodwill existed on the Petition Date subject to JSN liens.

The Defendants use two methods to calculate goodwill on the Petition Date. First, they look to the Ocwen and Walter asset sale and calculate a present value of the goodwill in that sale as of the Petition Date. Second, the Defendants perform a “top down” analysis of the intangibles associated with the MSRs and servicing and originating platforms, including goodwill. While Houlihan's methodologies may have been textbook, the assumptions and inputs they used were seriously flawed. As a result, Houlihan's conclusions regarding the values of intangibles and goodwill are not credible.

Regarding the first method, the Court cannot conclude that any goodwill derived from the Ocwen and Walter sale existed on the Petition Date. The value of the **Debtors'** assets on that date was seriously impaired, subject to steep reductions in value by litigation risks, potential seizure of certain MSRs, and termination of rights and setoff by the RMBS Trustees. Ocwen and Walter, the eventual buyers, were not committed to paying the **Debtors** anything for their assets on the Petition Date, let alone a price above the fair value of the **Debtors'** assets and liabilities. The **Debtors** facilitated the asset sale to Ocwen and Walter by maintaining the value of the assets throughout the bankruptcy, along with decreasing the liabilities associated with those assets. The **Debtors** worked very hard at substantial expense to achieve settlements and consents that allowed the sales to close. If the **Debtors** had not taken those actions, Ocwen and Walter may not have bought any assets at all, and likely would not have paid any price above the fair value of the assets and liabilities. To be sure, there may have been name recognition or special market relationships associated with the **Debtors'** assets on the Petition Date, but that name recognition or those relationships could have been valueless in the eyes of a buyer on the Petition Date. The Court cannot indulge the speculation that the Ocwen and Walter purchase price provides an adequate starting point for the goodwill that would have been generated by an asset sale on the Petition Date. After all, “goodwill often fluctuates widely for innumerable reasons.”  *Sanders*, 209 F.3d at 1002.

As for the “top down” valuation, the Plaintiffs raised serious problems with the Defendants' market **multiple** analysis that provided the starting point for the “top down” valuation. *First*, the Defendants' expert Mr. Fazio acknowledged that his market **multiple** analysis only weighed comparable companies in terms of their equity, rather than their total enterprise value. (Oct. 22 Tr. 198:20–199:6; 199:19–22.) *Second*, Mr. Fazio's analysis failed to account for any value that would be attributable to the **Debtors'** servicing advances. (Oct. 22 Tr. 200:1–22; DX ABG at 35, 38, 41.) Since those assets were not properly accounted for, and were not properly deducted from Mr. Fazio's valuation, it is possible that what the Defendants concluded was goodwill actually represented value attributable to servicing advances. Thus, the Defendants' second method for determining goodwill is unpersuasive.

Having failed to provide an adequate basis for valuing goodwill on the Petition Date, the JSNs have not met their burden in demonstrating the extent of their lien on goodwill as of the Petition Date.

***612** e. The JSNs Do Not Have a Lien on Goodwill Generated after the Petition Date.

[19] Although the JSNs have a lien on the proceeds of their prepetition collateral, any goodwill generated in connection with the assets sold to Ocwen and Walter was not the proceeds of that collateral and is not subject to JSN liens. *Bankruptcy Code Section 552(b)* provides that if a prepetition security agreement extends to proceeds of collateral, then postpetition proceeds would also be subject to that security agreement, unless the court orders otherwise after a hearing based on the equities of the case. *11 U.S.C. § 552(b)*. The JSN Security Agreement granted the JSNs a lien on “all Proceeds, products, offspring, rents, issues, profits and returns of and from, and all distributions on and rights arising out of any of the [collateral described in the JSN Security Agreement].” (PX 4 at 17.) Additionally, the Cash Collateral Order provided that the proceeds of prepetition JSN Collateral are “deemed to be cash collateral of the [JSNs].” (PX 76 at 22.) To establish a lien on the goodwill created by the Ocwen sale, the JSNs would need to demonstrate that the goodwill was the product of their prepetition collateral. They did not meet this burden.

“*Section 552(b)* is intended to cover after-acquired property that is directly attributable to prepetition collateral, *without addition of estate resources*.” 5 COLLIER ON BANKRUPTCY ¶ 552.02[2][a] (emphasis added). Here, even if JSN Collateral was used to generate goodwill (either by maintaining or improving the value of assets or by diminishing liabilities), **Debtor** resources were used as well. The **Debtors** improved the value of the assets sold to Ocwen by negotiating settlements with government entities and RMBS Trustees. That involved time, effort, and expense by the **Debtors'** estates. The **Debtors** did not merely take some JSN Collateral and convert it into goodwill without any other resources. That means that the goodwill is not the proceeds of JSN Collateral. See *In re Delco Oil, Inc.*, 365 B.R. 246, 250 (Bankr.M.D.Fla.2007) (“The concept of proceeds is only implicated when one asset is disposed of and another is acquired as its substitute.”) (internal quotation marks omitted). Even if a portion of

the goodwill was directly attributable to JSN Collateral, without any other additional resources, the JSNs have failed to separate the value of that goodwill. Thus, the JSNs have not met their burden of establishing a lien on goodwill generated postpetition.

6. Miscellaneous Collateral Categories

a. The JSNs Have Liens on the “Contested Assets.”

[20] The JSNs claim to have liens on “Contested Assets,” which consist of (1) the Former Bilateral Facilities Collateral and (2) the Reacquired Mortgage Loans. The Court has previously ruled that the JSN Security Agreement is ambiguous with respect to “whether an Excluded Asset becomes part of the Secured Parties’ collateral pursuant to the All–Asset Granting Clause once it ceases to constitute an Excluded Asset.” *Residential Capital*, 495 B.R. at 262. Where a contract is ambiguous, courts may consider extrinsic evidence in order to determine the parties’ intended meaning. See *Bank of New York Trust Co., N.A. v. Franklin Advisers, Inc.*, 726 F.3d 269, 276 (2d Cir.2013) (stating that a principle of New York contract law is that, “if contract terms are ambiguous, the court may accept any available extrinsic evidence to ascertain the meaning intended by the parties during the formation of the contract”) (citations omitted). Extrinsic evidence can include testimony of the parties’ intent. See *613 *Webb v. GAF Corp.*, 936 F.Supp. 1109, 1124 (N.D.N.Y.1996) (“The court is of the opinion that testimony regarding the understandings of the parties ... was both competent and helpful to the triers of fact....”).

Having the benefit of a full evidentiary record, including an examination of both the contractual language and the extrinsic evidence provided by witness testimony, the Court concludes that the JSN Security Agreement grants the JSNs liens on the Contested Assets.

i. The JSNs Have Liens on the Collateral Released from the Bilateral Facilities.

The Plaintiffs argue that the JSNs do not have a lien on the Former Bilateral Facilities Collateral, which has an alleged fair market value of approximately \$24 million.⁴⁴ The Plaintiffs argue that the JSNs were never granted liens in the Former Bilateral Facilities Collateral because the underlying loans were originally Excluded Assets. Additionally, the Plaintiffs assert that no “springing lien” exists with respect to the Former Bilateral Facilities Collateral and, even if it did, the JSN Security Agreement is ambiguous whether the Former Bilateral Facilities Collateral automatically reverted to JSN Collateral before the Petition Date when the reason for the exclusion of the Former Bilateral Facilities Collateral no longer existed. The Plaintiffs contend that the testimony presented at trial did not sufficiently establish a course of dealing among the parties. The Defendants argue that even though the Former Bilateral Facilities Collateral consists of assets that were carved out of the JSN Collateral as “Excluded Assets” at the time the JSN Security Agreement was executed, the collateral was subsequently released from Bilateral Facilities before the Petition Date and treated as AFI and JSN Collateral. The Court finds that the JSNs have liens on the Former Bilateral Facilities Collateral.

The JSN Security Agreement provides that “the ‘Collateral’ ... shall not include Excluded Assets.” (PX 4 § 2.) “Excluded Assets” in turn means, in relevant part:

(c) any asset ... to the extent that the grant of a security interest therein would violate applicable Requirements of Law, result in the invalidation thereof or provide any party thereto with a right of termination or default with respect thereto or with respect to any Bilateral Facility to which such asset is subject as of the Issue Date....

(*Id.* at 4–15).

The testimony presented at trial revealed that employees for both the **Debtors** and AFI understood the JSN Security Agreement and the All–Asset Granting Clause to convert the Former Bilateral Facilities Collateral to Notes Collateral when the Bilateral Facilities terminated or when collateral was released from those facilities. The witnesses also testified that once an asset that otherwise fell within the scope Blanket Lien was released from a Bilateral Facility, that asset would become part of the JSN Collateral. Lara Hall testified at her deposition that “AFI’s intent was as soon as the assets rolled off the bilateral facility, they would become subject to the blanket lien.” (Hall Dep. 123:19–23.) She also said that “[t]he blanket lien basically suggested that anytime an asset became uncovered, it would be subject to the blanket lien.” (*Id.* at 116:6–14.) Joseph Ruhlin, the **Debtors’** former Treasurer, testified in his deposition that the **Debtors** understood the Former Bilateral Facilities Collateral “would be covered by the blanket lien as long as they ... were owned [by the **Debtors**] and not *614 pledged elsewhere to another bilateral facility,” and that the **Debtors’** “understanding” was that “once an asset was released from a funding facility, depending on the asset, it would become part of the blanket lien.” (Ruhlin Dep. 89:14–25; 93:8–14, 165:5–9.) Ms. Farley, the **Debtors’** appointed 30(b)(6) witness on the assets constituting JSN Collateral, testified that Former Bilateral Facilities Collateral would “absolutely” become JSN Collateral when the Bilateral Facilities terminated, “[t]o the extent they fell within the security grant.” (Oct. 16 Tr. 186:24–187:9.)

Finally, the **Debtors** were told by their outside counsel via email in December 2008 that “if at any point while owned by GMAC [] the assets are removed from a Bilateral Facility, the [AFI] Revolver and [JSN] Indenture liens may cover these assets and they will constitute Collateral (if and to the extent Sections 9–406/8 of the U.C.C. are applicable).” (DX ES at 1.) The extrinsic evidence presented at trial indicates that the parties to the JSN Security Agreement understood and intended that the JSN Collateral would include Former Bilateral Facilities Collateral. The Court therefore finds that the JSNs have liens on the Former Bilateral Facilities Collateral.⁴⁵

ii. The JSNs Have Liens on the Released and Reacquired Collateral.

The Plaintiffs seek a declaration that the Defendants have not perfected any interest in the Reacquired Mortgage Loans. According to the Plaintiffs, even if the JSNs retained a continuing security interest in the Released Mortgage Loans when those assets were re-acquired by the **Debtors**, which the Plaintiffs contest, the JSNs never perfected their security interest, and it is avoidable. The Defendants contend that (1) the Reacquired Mortgage Loans are assets that were initially JSN Collateral, subsequently released by the Collateral Agent in May 2010 so that they could be sold to a Repo Facility, and then reacquired by the **Debtors** between September 2010 and the Petition Date, thereby falling within the scope of the Blanket Lien, and (2) the JSNs’ lien on the Reacquired Mortgage Loans is perfected because the original U.C.C. filings perfecting those liens provided adequate notice to potential creditors. The book value of the Reacquired Mortgage Loans is approximately \$14.1 million and has an alleged fair market value of approximately \$10 million.⁴⁶

The Court finds that the Defendants have perfected liens on the Reacquired Mortgage Loans.

(a) The Reacquired Mortgage Loans Fall within the Blanket Lien’s Grasp.

[21] The Defendants argue that the loans that were released from the JSNs’ liens in May 2010 to be sold to the Citi and Goldman Repo Facilities and subsequently repurchased by the **Debtors** between September 2010 and the Petition Date are JSN Collateral due to the Blanket Lien. The Blanket Lien arises from the All–Assets Granting Clause expressly covering all of the **Debtors’** assets, “whether not or hereafter existing, owned or acquired and wherever located and howsoever created...” (JSN Security Agreement at 13.) “[U]nder the Uniform Commercial Code, *615 the proper perfection of a security interest may create an

enforceable lien in after-acquired property, without regard to any entitlement to an equitable lien under common law.”  *In re Minor*, 443 B.R. 282, 288 n.3 (Bankr.W.D.N.Y.2011) (citing N.Y. U.C.C. § 9-204 (2001)). A security interest “arising by virtue of an after-acquired property clause is no less valid than a security interest in collateral in which the **debtor** has rights at the time value is given ... no further action by the secured party—such as a supplemental agreement covering the new collateral—is required.” N.Y. U.C.C. § 9-204 cmt. 2 (2013).

No language in the JSN Security Agreement suggests that the Blanket Lien does not apply to ***616** the Reacquired Mortgage Loans. Instead, the **Debtors** and AFI's employees testified that they understood that assets sold and repurchased by the **Debtors** would become JSN Collateral upon their reacquisition. (See Oct. 16 Tr. 190:21–191:24 (when an asset that had been released from the JSN Collateral package to be sold to a third party was repurchased by the **Debtors**, “the blanket lien would pick it up”); Ruhlin Dep. 65:19–22, 66:6–14 (“[A]ssets such as loans that were acquired in the future would be subject to the lien,” and those assets could have been “[r]epurchases ... previously owned by ResCap,” or “[t]hey ... could be repurchased outside from a third party.”).) Thus, under the Blanket Lien, the Reacquired Mortgage Loans became JSN Collateral when the **Debtors** repurchased them.

(b) The JSNs' Interest in the Reacquired Mortgage Loans Is Perfected.

[22] The Plaintiffs argue that the U.C.C.–3 statements filed in May 2010 terminated the U.C.C.–1 financing statements as to these assets, rendering any security interests the JSNs had in the Reacquired Mortgage Loans unperfected. However, because the Court finds that the U.C.C.–1 financing statements continued in effect notwithstanding the filing of the U.C.C.–3 financing statements, the U.C.C.–1 statements operated to perfect the JSNs' security interests.

The U.C.C. employs a notice filing system requiring that a financing statement provide “a simple record providing a limited amount of information” that puts parties on notice to inquire further to ascertain “the complete state of affairs.” N.Y. U.C.C. § 9-502 cmt. 2. “UCC Article 9 only requires information sufficient to engage in further inquiry. When the authorization underlying a previously filed termination statement matters to a subsequent lender (as it usually will), the lender can simply include any necessary further inquiry as part of its due diligence.”  *Official Comm. v. JPMorgan Chase Bank, NA (In re Motors Liquidation Co.)*, 486 B.R. 596, 644 (Bankr.S.D.N.Y.2013). In cases where courts have addressed inconsistent financing statements, courts have found that the inconsistency in the statements itself was sufficient to put the creditor on notice. See  *In re A.F. Evans Co.*, No. 09–41727(EDJ), 2009 WL 2821510, at *5 (Bankr.N.D.Cal. July 14, 2009) (“Here, CNB's financing statements, as amended by the U.C.C.–3 Amendment statements, each with two conflicting boxes checked [(a termination box plus a release of collateral box)], would raise a red flag for any person conducting a search alerting such person of the possibility that a full termination may not have been intended.”).

In this case, because the U.C.C.–1s were on file, potential lenders were on notice to investigate the extent of the JSNs' security interest in the Reacquired Mortgage Loans notwithstanding the U.C.C.–3s relating to those assets. After further inquiry, they would have been informed that the Reacquired Mortgage Loans were automatically pledged once again to AFI and the JSNs under the Blanket Lien, and were coded first as unpledged and later as Blanket Lien Collateral in the CFDR. (See Farley Dep. 95:3–14, 110:5–111:14, 115:4–14, 137:21–24, 138:4–11, 176:21–177:3; Oct. 16 Tr. 190:21–192:18; Hall Dep. 117:6–12; Ruhlin Dep. 65:19–22, 66:6–21, 106:8–12, 119:4–9, 155:16–156:2, 156:15–21.)

For the foregoing reasons, the Court finds that the JSNs' interest in the Reacquired Mortgage Loans was perfected, and the JSNs are entitled to their lien on the released and reacquired collateral.

b. The JSNs Have Liens on a Portion of the Deposit Accounts.

[23] The Plaintiffs also challenge JSN liens on certain deposit accounts, which the Plaintiffs refer to as “Avoidable Deposit Accounts.”⁴⁷ The Avoidable Deposit Accounts hold approximately \$48.4 million. The Plaintiffs allege that the JSNs have not perfected their security interests in the Avoidable Deposit Accounts.

[24] The Court finds that, except for the Controlled Accounts and the WF Accounts, the JSNs do not have perfected liens on the Avoidable Deposit Accounts. Under the U.C.C., “a security interest in a deposit account may be perfected only by control” of the account. N.Y. U.C.C. § 9–312(b)(1). A secured party has control of a deposit account if: “(1) the secured party is the bank with which the deposit account is maintained; (2) the debtor, secured party, and bank have agreed in an authenticated record that the bank will comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or (3) the secured party becomes the bank’s customer with respect to the deposit account.” *Id.* at § 9–104(a)(1)–(3).

The parties requested executed control agreements in discovery. (Landy Direct ¶ 40.) The Defendants offered evidence of control agreements for certain accounts (the “Controlled Accounts”). (See DX AIU; DX AIV; DX AIW; DX AIX; DX AIY; DX AIZ.) Given the control agreements, the JSNs have established control over those accounts. Additionally, the Plaintiffs concede that certain accounts the Committee initially challenged are controlled by Wells Fargo, which is the Third Priority Collateral Agent. Since Wells Fargo controls those accounts and is the secured party for the Junior Secured Notes, the JSNs have sufficiently established control over the WF Accounts. The Court finds that the Controlled Accounts and the WF Accounts are the only Deposit Accounts over which the JSNs have established control.

The JSNs claim to have liens on certain Ally Bank accounts by virtue of Ally’s corporate relationship with AFI, the Revolver Lender. But Ally and AFI are not the same entity. The JSNs cannot establish control over Ally Bank accounts due to the corporate relationship between Ally and AFI. And even if AFI had control over those accounts by virtue of its relationship with Ally Bank, that would not benefit the JSNs.

Under the U.C.C., the Notes Trustee has the burden of tracing funds to “identifiable cash proceeds” of collateral that would be automatically perfected under U.C.C. § 9–514(c). U.C.C. § 9–315. See also *In re Milton Abeles, LLC*, No. 812–70158–reg, 2013 WL 530414 at *2 (Bankr.E.D.N.Y. Sept. 20, 2013) (“[S]ection 9–315 *617 provides that ‘proceeds’ of a secured creditor’s collateral must be ‘identifiable proceeds.’ Proceeds that are commingled with other property are ‘identifiable’ only if ‘the secured party identifies the proceeds by a method of tracing.’ ”); *Matter of Guaranteed Muffler Supply Co., Inc.*, 1 B.R. 324, 330 (Bankr.N.D.Ga.1979) (“secured parties bear the burden of identifying, or tracing, the proceeds obtained upon the sale of property in which they have an interest ...”). But for a single account that the Plaintiffs concede contains proceeds of JSN Collateral, the Defendants have failed to provide sufficient evidence that any deposit accounts contain proceeds of JSN Collateral.

After excluding the Controlled Assets, the WF Accounts, and the proceeds account, the amount of funds in the remaining deposit accounts (i.e., the Avoidable Deposit Accounts) as of the Petition Date was \$48,439,532. Accordingly, the JSNs do not have a lien on the Avoidable Deposit Accounts pursuant to sections 544(a)(1)–(2) of the Bankruptcy Code. The property or the value of the property represented by the Avoidable Deposit Accounts should be recovered and/or preserved for the benefit of the Debtors’ estates pursuant to sections 550(a) and 551 of the Bankruptcy Code.

For the foregoing reasons, the Court finds that the value of the JSNs’ collateral should be reduced by \$48,439,532, the amount of cash in the Avoidable Deposit Accounts as of the Petition Date.

c. The JSNs Do Not Have a Lien on the Unencumbered Real Property.

[25] [26] To perfect a lien on real property, a secured party must execute a mortgage or a deed of trust and duly record it against the title of such real property. See *In re Churchill Mortg. Inv. Corp.*, 233 B.R. 61, 70 (Bankr.S.D.N.Y.1999) (“Under the  [New York Real Property Law § 291](#), a security interest in real property can be perfected only by filing written notice with the Clerk of the County where the property is located so that the lien may be publicly recorded, giving notice of the encumbrance to potential purchasers or future creditors.”). The Court finds that the JSNs do not have a perfected security interest in or lien on any of the Unencumbered Real Property because that property was not subject to an executed and filed mortgage or deed of trust. Accordingly, any JSN lien with respect to the Unencumbered Real Property is avoidable pursuant to [sections 544\(a\)\(1\) and \(2\) of the Bankruptcy Code](#), and the property or the value of the property represented by the Unencumbered Real Property should be recovered and/or preserved for the benefit of the **Debtors**’ estates pursuant to [sections 550\(a\) and 551 of the Bankruptcy Code](#).

For the foregoing reasons, the Court finds that the value of the JSNs’ collateral should be reduced by \$21 million, the fair market value of the Unencumbered Real Property as of the Petition Date.

7. The Plaintiffs Failed to Establish Preferential Transfers to the JSNs.

The Plaintiffs seek to avoid \$270 million of the JSNs’ claim as preferential transfers (the “Alleged Preferential Transfers”). The Alleged Preferential Transfers, listed on Schedule 6 to the Committee’s complaint (PX 127), consist of (1) mortgage loan instruments, including HFS Loans and FHA/VA loans, (2) REO property, and (3) government insurance claims arising as a result of expenditures incurred by the **Debtors** in connection with FHA/VA *618 Loans.⁴⁸ The Plaintiffs contend that these assets first became JSN Collateral on or after February 29, 2012, during the Modified Preference Period.⁴⁹ To prove this contention, the Plaintiffs point to how the collateral was recorded in the CFDR as of February 29, 2012, and as of the Petition Date. As such, the Plaintiffs claim to have met their prima facie burden of proof for a preference claim under  [Bankruptcy Code sections 547\(b\)\(1\)-\(5\)](#).

The Defendants offer two reasons why the Plaintiffs are not entitled to avoid the Alleged Preferential Transfers: (1) the Plaintiffs failed to make a prima facie case for avoidance, and (2) even if the Plaintiffs could make such a showing, their Preference Claim is barred by the “improvement in position test.” Because the Court concludes that the Plaintiffs have failed to make a prima facie case for avoidance of the Alleged Preferential Transfers the Court need not consider the “improvement in position test.”

[27]  [Section 547\(b\) of the Bankruptcy Code](#) “permits a trustee to avoid certain prepetition transfers as ‘preferences.’”⁵⁰ 5 COLLIER ON BANKRUPTCY ¶ 547.01.  [Section 547\(b\)](#) lays out the elements of an avoidable preference as a transfer of an interest in **debtor** property:

- (1) to or for the benefit of a creditor;
- (2) for or on account of an antecedent debt owed by the **debtor** before such transfer was made;
- (3) made while the **debtor** was insolvent;
- (4) made—
 - (A) on or within 90 days before the date of the filing of the petition; or
 - (B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and
- (5) that enables such creditor to received more than such creditor would receive if—

- (A) the case were a case under chapter 7 of this title;
- (B) the transfer had not been made; and
- (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

 11 U.S.C. § 547(b). Unless the trustee proves each and every one of these elements, a transfer is not avoidable as a preference under  section 547(b). See 11 U.S.C. § 547(g) (“For the purposes of this section, the trustee has the burden of proving the avoidability of a transfer under subsection (b) of this section”); see also  *Waldschmidt v. Ranier (In re Fulghum Constr. Corp.)*, 706 F.2d 171, 172 (6th Cir.1983) (“As is facially evident from this provision, all five enumerated criteria must *619 be satisfied before a trustee may avoid any transfer of property as a preference.”).

a. The Plaintiffs Failed to Show that the JSNs Were Undersecured as of February 29, 2012.

[28] The Defendants argue that the Plaintiffs failed to make a showing that the JSNs were undersecured at the start of the Modified Preference Period, immunizing them “from [a] preference attack because [they] would have been paid in full in a hypothetical Chapter 7 liquidation by virtue of [their] realization on [their] collateral.”  *Official Comm. v. AAF-McQuay (In re 360networks(USA), Inc.)*, 327 B.R. 187, 190 (Bankr.S.D.N.Y.2005); see also *In re Santoro Excavating, Inc.*, 32 B.R. 947, 948 (Bankr.S.D.N.Y.1983) (“[A] payment [during the preference period] to a creditor with an allowed fully secured claim is not a preference.”) (collecting cases). Where a creditor asserts that it was oversecured at the time of the alleged preferential transfer, it is the plaintiff's burden to refute that assertion. See *Savage & Assocs., P.C. v. Cnty. of Fairfax (In re Teligent, Inc.)*, No. 01–12974(SMB), 2006 WL 1030417 at *3 (Bankr.S.D.N.Y. Apr. 13, 2006) (“Teligent II”) (“[W]here the defendant in a preference action asserts that it was oversecured, the plaintiff must prove a negative, to wit that the defendant was not oversecured.”), *aff'd sub nom In re Teligent Servs. Inc.*, No. 06 Civ. 03721(KMW), 2009 WL 2152320 (S.D.N.Y. July 17, 2009) (“Teligent III”). A defendant's assertion that it was fully secured is not a defense pursuant to  section 547(c), but “rather a negation of one of the elements of a preference action, pursuant to  section 547(b).” *Teligent III*, 2009 WL 2152320, at *6.

[29] Throughout this case, the Defendants have maintained that they were oversecured as of the start of the Modified Preference Period, placing the burden squarely on the Plaintiffs to prove that the Defendants were not oversecured. While the Plaintiffs' expert Mr. Puntus provided a proposed valuation of the JSNs' collateral as of the Petition Date,⁵¹ he did not calculate the value as of the start of the Modified Preference Period. In fact, none of the Plaintiffs' experts provided a valuation of the JSN Collateral at the beginning of the Modified Preference Period, or at any time during that period. As a result, the Plaintiffs have failed to satisfy  section 547(b)(5) and are not entitled to avoid the portion of the Defendants' liens related to the so-called “Preferential Transfers.”

b. The Plaintiffs Failed to Prove the Identity or Scope of Transfers of Collateral to Defendants During the Modified Preference Period.

Even assuming that the Plaintiffs had shown that the Defendants were undersecured at the beginning of the Modified Preference Period, the Plaintiffs have failed to show the identity or scope of these Alleged Preferential Transfers. The Plaintiffs' only evidence in support of their preference claim, the CFDR, is reliable as a business record to establish when AFI LOC Collateral was properly released, but it is not sufficient to establish the identity or scope of the Alleged Preferential Transfers. The Plaintiffs' expert Mr. Landy identified the Alleged Preferential Transfers by performing a comparison of CFDR extracts as of February 29, 2012, and the Petition Date. (Oct. 17 Tr. 152:16–153:13, 162:12–15.) He concluded that any asset appearing in the CFDR for the

first time as JSN Collateral during the Modified *620 Preference Period was a preferential transfer, though he “did not attempt to understand the circumstances for why each loan may have appeared on 5/13....” (Oct. 17 Tr. 153:10–22; 155:5–7.) Indeed, the CFDR contains little information explaining why an asset would appear for the first time or reappear after an absence in the database. (See PX 139.) At trial, the Defendants raised a variety of explanations why these assets may have appeared in the CFDR during the Modified Preference Period, tending to negate their status as preferential transfers. For example, the loans may have been modified, repaid in full and then subsequently drawn upon, or they may represent refinancings of old loans that formerly constituted JSN Collateral. (Oct. 22 Tr. 26:23–27:9, 28:3–10, 31:18–32:15, 33:18–34:4, 35:18–21, 42:14–43:3, 56:25.) Under any example, they would not be preferential transfers.

The Defendants' expert Mr. Winn specifically identified a variety of alleged “Preferential Transfers” that should not have been included in Schedule 6. (DX ABN 12 (“[T]he CFDR shows that approximately \$18 million of the alleged Preference Assets were owned by the Debtors and served as JSN Collateral as of or prior to 2/29/12 and thus should not be listed as Preference Assets.”).) Mr. Landy, who prepared Schedule 6, conceded that certain of these assets were inaccurately included on Schedule 6. (See Landy Direct ¶ 56 (“I have determined that I concur with Mr. Winn's observations regarding (a) 18 loans identified as ‘FHA/VA Reclassified as Loans HFS’ ... with a net book value of approximately \$1.95 million, and (b) 2 loans identified as ‘REO Reclassified as Loans’ ..., with a net book value of \$50,478.”) (“Mr. Winn identifies approximately \$12 million of ‘REO’ assets that were pre-existing components of the JSN Collateral pool as of February 29, 2012, and were therefore never transferred to or for the benefit of the JSNs during the preference period.”).) Specifically, Mr. Landy concurred with Mr. Winn's conclusions that the following do not constitute preferential transfers:

- The FHA/VA assets for which no Loan Funding Date exists within the CFDR and for which the Debtors have provided no information nor conducted any inquiry whether such assets are refinancings (despite the acknowledgment that such assets could be refinancings);
- The approximately \$12 million of REO assets which the Committee's expert Marc E. Landy concedes were within the CFDR in the JSN Collateral before the Modified Preference Period. The Committee seeks to avoid these assets “to the extent ... ownership of these REO properties was transferred ... to an REO special purpose vehicle during the preference period,” yet offered no evidence that such transfers to special purpose vehicles occurred during the Modified Preference Period;
- The HFS loans appearing for the first time in the CFDR during the Modified Preference Period with Loan Funding Dates before the Modified Preference Period, for which neither the Committee nor the Debtors can offer a reasonable and consistent explanation, the majority of which have “Loan Modification Dates” and a portion of which are coded as HELOCs (suggesting that their appearance is the result of loan modifications or draws on HELOCs); and
- The HFS and FHA/VA loans that appeared in the CFDR before the Modified Preference Period, disappeared from the CFDR and reappeared within the CFDR during the Modified Preference Period.

Given these errors, appearance in the CFDR alone cannot be enough to identify *621 a preferential transfer. Too many questions and inconsistencies remain to conclude that the JSNs first acquired an interest in these assets during the Modified Preference Period. Thus, the Plaintiffs have failed to prove the identity and scope of the Alleged Preferential Transfers and are not entitled to avoid this portion of the JSNs' claim.

8. The Plaintiffs Are Not Entitled to Charge the JSNs with a \$143 Million Carve Out Payment If the Plaintiffs Can Pay Professional Fees and Administrative Expenses with Unencumbered Cash.

The Plaintiffs seek a declaration permitting them to charge up to an additional \$143 million in Carve Out expenses, thereby further reducing the JSNs' secured claim on the Effective Date. The Court holds that the Plaintiffs are not entitled to this declaration if they can pay fees and expenses with unencumbered cash. While this case is not over, it appears that the Debtors have substantial unencumbered cash available to pay administrative expenses.

[30] A carve out is a provision of a cash collateral order that allows for some expenditure of administrative and/or professional fees to be paid before a secured creditor gets paid on its collateral. See [In re Blackwood Associates, L.P.](#), 153 F.3d 61, 68 (2d Cir.1998) (stating that “absent an agreement to the contrary, a secured creditor’s collateral may only be charged for administrative expenses, including attorney’s fees, to the extent these expenses directly benefited that secured creditor,” but “if a secured party consents to allowing such administrative expenses, that party may be liable for such expenses even in the absence of conferred benefit”); 3 COLLIER ON BANKRUPTCY ¶ 364.04[2][d] (“A carve-out gives the benefitted claimants a priority in the postpetition lender’s collateral ahead of the lender’s priority and, if the carve-out is for the benefit of only certain named administrative claimants, above other administrative claimants as well.”); Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445, 445 (2002) (“As generally used, a carve out is an agreement between a secured lender, on the one hand, and the trustee or **debtor** in possession ... on the other, providing that a portion of the secured creditor’s collateral may be used to pay administrative expenses.”).

[31] The Bankruptcy Code does not deal with carve out provisions typically included in cash collateral orders. See [In re White Glove, Inc.](#), No. 98–12493 DWS, 1998 WL 731611 at *6 (Bankr.E.D.Pa. Oct. 14, 1998) (“The term ‘carve out’ is one of those uniquely bankruptcy phrases, much like ‘cram down,’ that appears nowhere in the bankruptcy statute but connotes definite meaning to the parties.”); see also Levin at 445 (“Unlike ‘cram down,’ ... which has a relatively well-defined meaning derived from ¶ 1129(b) of the Bankruptcy Code, ‘carve out’ does not derive its substance from any particular section of the Bankruptcy Code.”). Unless it conflicts with provisions of the Bankruptcy Code, a carve out is construed applying normal contract interpretation provisions. See [Blackwood](#), 153 F.3d at 67 (applying “the statutory context underlying cash collateral stipulations[] and the text of the Stipulation itself” to conclude that a disputed carve out provision did not grant the **chapter 11 debtor’s** counsel payment from cash collateral when the **debtor** failed to meet the terms of the cash collateral stipulation).

[32] The usual purpose of a carve out is to assure the payment of specified administrative expenses from a secured creditor’s *622 collateral in the event that the case goes badly, use of cash collateral is terminated, and sufficient unencumbered funds are no longer available to administer the case, usually after conversion to chapter 7. See Levin at 451 (“The carve out becomes important to the protected administrative claimants *only* when the unencumbered assets in the bankruptcy estate that remain after application of the collateral proceeds to the secured claim are not adequate to pay all administrative claims, so that the administrative claimants will need to look to the carve out as an alternative source for payment.”) (emphasis added).

[33] Here, the Cash Collateral Order controls the priority of the JSN liens with respect to the Carve Out. The Final Cash Collateral Order creates a Carve Out from the JSNs’ cash collateral that subjects and subordinates the JSN liens to the Carve Out amount but does not otherwise affect the validity of the JSN liens on carved out JSN cash collateral:

the [JSN Liens] are valid, binding, perfected, and enforceable first priority liens on and security interests in the personal and real property constituting “Collateral” under, and as defined in, the Junior Secured Notes Documents ... and (iii) are subject and subordinate only to (A) the liens and security interests granted to the AFI Lender under the AFI Revolver, all subject to the terms and conditions of the Intercreditor Agreement, dated as of June 6, 2008 ..., (B) the Carve Out, and (C) the liens and security interests granted to secure the Adequate Protection Obligations....

(PX 76 at 11–12.) The Carve Out, in turn, is defined as the sum of: (1) court and United States Trustee fees, (2) accrued and unpaid professional fees following a termination event in an aggregate amount not exceeding \$25 million (plus all unpaid professional fees allowed by the Court at any time that were incurred on or before the business day following the Carve Out Notice), and (3) unpaid professional fees that were allowed prior to the termination event; provided that,

(A) the Carve Out shall not be available to pay any such Professional Fees incurred in connection with the initiation or prosecution of any claims, causes of action, adversary proceedings or other litigation against the Adequate Protection Parties, (B) so long as no event of default shall have occurred and be continuing, the Carve Out shall not be reduced by the payment of fees and expenses allowed by the Court and payable under sections 328, 330 and 331 of the Bankruptcy Code, and (C) nothing in this Final Order shall impair the right of any party to object to any such fees or expenses to be paid by the Debtors' estates.

(*Id.* at 31–32.)

The Cash Collateral Order clearly requires the JSNs to subordinate their secured claim to the payment of the Carve Out, but is silent whether the Debtors may use those funds, further reducing the JSNs' secured claim, when other unencumbered funds are available. Absent contractual language requiring that result, the Court concludes that the Cash Collateral Order does not go beyond the ordinary purpose of assuring funds to pay the specified expenses if unencumbered funds are no longer available to do so.

The JSNs' liens remain subordinated to the Carve Out. If during the remainder of the case, unencumbered funds are no longer available to pay the expenses, the JSN Collateral can be used for that purpose. At this stage, however, there is no reason to believe that will occur. The Court holds that the JSNs' Collateral should not be reduced at this time.

***623 E. Given the Court's Findings on What Constitutes JSN Collateral, the JSNs are Undersecured.**

Notwithstanding the JSNs' ability to aggregate their collateral across debtors, the Court finds that, as of the conclusion of Phase I, the JSNs are undersecured and not entitled to postpetition interest and fees.⁵² As of the Petition Date, the JSNs held secured claims against ResCap, and certain of its affiliates as guarantors and grantors, in the face amount of \$2.222 billion, consisting of \$2.120 billion in unpaid principal as of the Petition Date, and \$101 million in unpaid prepetition interest. (DX ABF at 3.) As the Court discussed in section III.A above, the JSNs' claim will not be reduced by unamortized OID. Assuming an effective date of December 15, 2013, the JSNs will assert a claim for postpetition interest at the default rate, in the amount of \$342 million. (JSN Corrected Proposed Findings of Fact, ECF Doc. # 190 § II ¶ 15.) The JSNs are only entitled to receive postpetition interest up to the value of their collateral. 11 U.S.C. § 506(b). Thus, to receive their full claim for postpetition interest, the JSNs have to establish an effective date value of their collateral of at least \$2.564 billion. At this point in the case, they fall well shy of the mark.

The parties have largely agreed on \$1.888 billion as a baseline estimation of the Effective Date value of the JSN Collateral. (DX AIR at 5.) The Plaintiffs seek to subtract from the baseline; the Defendants seek to add to it. Based on the Court's rulings, the following amounts will be added to the baseline:

- \$40 million in equity held at certain non-Debtors;
- \$17 million for a net increase in the value of the FHA/VA Loans;
- \$18.395 million for software; and
- \$10 million for tradename, iconography, and logotype.

The following amounts will be subtracted from the baseline:

- \$48,439,532 in Deposit Accounts (the JSNs retain an interest in \$63,297); and

- \$20.8 million of unencumbered real property.

Based on the Court's ruling, the following factors will not affect the baseline valuation:

- The Plaintiffs may not charge an additional \$143 million of expenses to the JSNs' collateral under the cash collateral carve out at this time.
- The Plaintiffs have not carried their burden in proving any preferential transfers.
- The JSNs do not have a lien on the \$1.1 billion of AFI LOC Collateral.
- The JSNs have a lien on \$24 million of Former Bilateral Facilities Collateral.
- The JSNs have a lien on \$10 million of Reacquired Mortgage Loans.
- The JSNs are not entitled to a \$66 million allocation from sale proceeds for net increases in HFS Collateral.
- The JSNs do not have a lien on any other intangibles or goodwill.

Based on the above findings, the JSNs have established that the Effective Date value of their collateral is \$1,904,155,468. Because their claim is for the face amount of \$2.222 billion, the JSNs are undersecured at the end of Phase I. A final determination of the extent of their security will *624 be deferred until after Phase II of the trial.

IV. CONCLUSION

The Phase I trial presented a large number of complex factual and legal issues requiring extraordinary time and expense for the parties and considerable effort for the Court to reach a result leaving the JSNs substantially undersecured. The JSNs have achieved that result in a case in which the proposed **plan** would pay the JSNs *all* prepetition principal and interest. The JSNs have pursued from the start a strategy where they contest everything and concede nothing (even when the Court has questioned whether they are acting in good faith). The JSNs have made clear that they will continue to follow the same strategy in the Phase II trial and contested confirmation hearing beginning on November 19, 2013.

The Court will continue to decide all issues fairly (the JSNs did prevail on some of the important issues in the Phase I trial), but it should not be lost on anyone that the JSNs stand virtually alone in this case in failing to reach a consensual agreement to resolve their issues. The result has been protracted proceedings that have burdened the estate and reduced funds available to satisfy creditor claims. That is unfortunate!

All Citations

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Footnotes

- 1 The value of the JSNs' purported adequate protection claim will increase or decrease based on the value of the JSNs' Collateral on the Petition Date and on the Effective Date. This Opinion will resolve some issues relating to both values.
- 2 All docket numbers listed refer to the Adversary Proceeding Docket 13–01277, unless otherwise noted.

- 3 [Date] Tr. [Citation] refers to transcripts of the Phase I trial. References to [Name] Direct [Citation] refer to direct testimony submitted in writing before the trial began and available on the public docket. Plaintiffs' exhibits are referenced by number (e.g., PX 1), and Defendants' exhibits are referenced by letter (e.g., DX A). All references to page numbers in the Plaintiffs' exhibits refer to the PX page numbers at the bottom of each page (e.g., PX 1 at 51 refers to PX 1 at page 51 of 120.) All references to page numbers in the Defendants' exhibits refer to the DX page numbers at the bottom of the each page. References to [Name] Dep. [Citation] refer to the deposition testimony designated for the Phase I trial. Citations to "PTO ¶ ___" are to the stipulated facts contained in the Revised Joint Pretrial Order entered in the consolidated adversary proceedings. (ECF Doc. # 161.)
- 4 Any remaining objections to deposition designations are overruled.
- 5 Although Wells Fargo is also a defendant, this opinion refers to UMB and the Ad Hoc Group as the "Defendants" to simplify referring to those parties.
- 6 Paragraph 16(c)(v) of the Final CashCollateral Order provides that the JSNs are entitled to, as part of adequate protection, prompt payment of reasonable fees and expenses, whether accrued prepetition or postpetition, for certain identified professionals. (PX 76 at 30.) The provision also provides that "nothing shall prejudice the rights of any party to seek to recharacterize any such payments ... as payments of principal under the Junior Secured Notes." (*Id.*) The issue was not addressed by the parties during the Phase I trial.
- 7 On June 20, 2012, the Court directed that an examiner be appointed (ECF 12–12020 Doc. # 454). On July 30, 2012, the Court approved *Arthur J. Gonzalez* as the examiner ("Examiner") (ECF 12–12020, Doc. # 674), and on June 26, 2013, the *Report of Arthur J. Gonzalez, as Examiner* was made publicly available (ECF Doc. # 3698).
- 8 The parties did not present evidence at trial of the value of the JSNs' collateral on a debtor-by-debtor basis, but instead focused on the aggregate value of the JSNs' collateral.
- 9 The "AFI Contribution" is a \$2.1 billion cash contribution AFI agreed to make to the Debtors' estates pursuant to the terms of the settlement among the Debtors, the Committee, AFI, and the Consenting Claimants set forth in Article IV of the Debtors' Joint Chapter 11 Plan.
- 10 During the trial, the Court determined that issues relating to liens on the AFI Contribution would be tried in Phase II.
- 11 The issues reserved for Phase II include (1) the value of intercompany balances, (2) the treatment of various claimant classes, (3) allocation of the AFI Contribution, (4) the value of collateral, oversecurity, and interest and fees if not determined in Phase I, and (5) a final calculation of the Defendants' adequate protection claim, if applicable. (*Id.*)
- 12 The Notes Indenture also provided that "[t]he [Borrower] will pay interest (including postpetition interest in any proceeding under any Bankruptcy Law) on overdue principal at the rate equal to 1% per annum in excess of the then applicable interest rate on the Notes to the extent lawful; it will pay interest (including postpetition interest in any proceeding under any Bankruptcy Law) on overdue installments of interest and Additional Interest (without regard to any applicable grace period) at the same rate to the extent lawful." (PX 1 § 4.01.)
- 13 The guarantor entities that are Debtors in these chapter 11 proceedings (the "Guarantor Debtors") guaranteed ResCap's obligations under the Notes Indenture, including the obligation to pay in full all principal, interest, fees, and premiums, if any, with respect to the Junior Secured Notes. (PX 1 § 10.01.)
- 14 ResCap also issued senior secured notes that were secured by the same collateral, but those notes were satisfied in full before the petition date and are not central to the present dispute.
- 15 See *infra* II.H.5 for discussion of Excluded Assets.
- 16 Pursuant to the JSN Security Agreement, the assets included "accounts, chattel paper, commercial tort claims, deposit accounts, financial assets, investment property, intellectual property, and general intangibles" of ResCap and the Notes Guarantors and Additional Grantors. (PX 4.) Although the JSN Security Agreement listed "Commercial Tort Claim described on Schedule V" as collateral, no commercial tort claims were identified or listed on Schedule V. Schedule V was never amended or modified. As a result, the Court previously found that the Defendants do not have a properly perfected lien on any Commercial Tort Claims. (See ECF Doc. # 100.)
- 17 A "Relevant Party" is an obligor under the Revolver Security Agreement or the JSN Security Agreement.
- 18 AFI was the Lender Agent.
- 19 FHA/VA loans are repurchased whole loans from Ginnie Mae trusts. (DX ABI at 58.) Since these assets are partially insured, the amounts paid by the Debtors to repurchase these loans are substantially reimbursable. (*Id.*) The Debtors

also have the choice of modifying or selling these Ginnie Mae repurchased loans to a Ginnie Mae trust or third party. (*Id.*) The **Debtors** always intended to sell the FHA/VA loans but ultimately pulled the FHA loans from the auction because they felt the bids received were not high enough. (Puntus Direct ¶ 117.)

20 The \$910 million questioned by the Ad Hoc Group is composed of four categories of assets (domestic mortgage loans, FHA/VA receivables, REO properties, and servicing advances) and three of these categories (comprising approximately 97% of the assets at issue) are covered by the Blanket Loan Release. Mortgage loans (\$550.4 million) and FHA/VA receivables (\$324.7 million) fall within the express definition of “Subject Mortgage Loans.” REO properties (\$5.9 million) are merely proceeds obtained upon foreclosure of mortgage loans and are therefore covered as well. (*See* DX AHD at 24 (setting forth the values of the various asset classes purportedly lacking evidence of release).) The last category of assets questioned by the Ad Hoc Group—servicing advances (\$29.4 million)—is covered by the Servicing Advance Release. The Servicing Advance Release covers Freddie Mac servicing advances (PX 130 at 1181–83), which were the only types of servicing advances pledged as collateral to the AFI LOC on the Petition Date. Farley Direct ¶ 62 & n.7. Therefore, the Servicing Advance Release covered all servicing advances that were pledged as collateral to secure the LOC Facility.

21 The servicing platform related to the MSRs includes, *inter alia*, software servicing contracts, employee contracts and certain other operating expenses relating to the MSRs (Oct. 15 Tr. 171: 8–17), and the origination platform related to the MSRs includes the call center. (Oct. 15 Tr. 172: 1–6.)

22 A significant modification of the FRB Consent Order—effectively reducing the **Debtors'** costs of compliance—was negotiated during this case and approved by the Court.

23 The Mini Auction resulted in increases in the sales prices by a total of \$150 million, as well as a reduction in the proposed break-up fees for the origination and servicing platform.

24 The Second Circuit explained the distinction between the two types of exchanges, writing:

An exchange offer made by a financially troubled company can be either a “fair market value exchange” or a “face value exchange.” In a fair market value exchange, an existing debt instrument is exchanged for a new one with a reduced principal amount, determined by the market value at which the existing instrument is trading. By offering a fair market value exchange, an issuer seeks to reduce its overall debt obligations.... A face value exchange, by contrast, involves the substitution of new indebtedness for an existing debenture, modifying terms or conditions but not reducing the principal amount of the debt.

 *Chateaugay*, 961 F.2d at 381–82 (citations omitted).

25 The GMAC Mortgage Services Advance Funding Company Ltd. (“GSAP”) Facility and the BMMZ Holding LLC Facility.

26 The “Former Bilateral Facilities Collateral” is referred to as “Released Bilateral Facilities Collateral” in the Committee's complaint and briefings by the Plaintiffs.

27 The parties dispute whether the amount of OID at the Petition Date is \$386 million (according to the Plaintiffs) or \$377 million (according to the Defendants). Since the Court concludes that the amount of the JSNs' claim should not be reduced by OID, the Court need not resolve this dispute.

28 *See supra* note 24 for the differences between fair market value and face value exchanges.

29 Here, the cash collateral motion was filed as a first day motion, so there is no issue of whether a later date should apply for purposes of an adequate protection claim. *See* 4 COLLIER ON BANKRUPTCY ¶ 506.03[7][a][iv] (“In general, courts typically hold that, for purposes of adequate protection, the value of the collateral is to be determined either as of the petition date or as of the date on which the request for adequate protection was first made.”).

30 There is no question here that the JSNs received adequate protection by a very substantial postpetition lien on collateral (far beyond the property covered by the JSNs' liens on the petition date). Had there been a contested cash collateral hearing the **Debtors** would have had the burden of establishing adequate protection; that was unnecessary because of the agreement of the parties. The issue now is different: Are the JSNs entitled to recover a claim based on a diminution in the aggregate value of their collateral at the petition date? As explained in the text, on that issue the JSNs have the burden of proof.

31 None of the cases cited by the Defendants support the proposition that in a post-hoc analysis of the sufficiency of adequate protection, the **debtor** continues to bear the burden of proving adequate protection. Rather, they all involve

- the well-established rule that, before a **debtor** may use, sell, lease, or otherwise encumber the lender's collateral, the **debtor** must show that the creditor's interest will be adequately protected. See [Swedeland](#), 16 F.3d at 564 (discussing whether adequate protection existed sufficient to grant a priming lien); [Wilmington Trust Co. v. AMR Corp. \(In re AMR Corp.\)](#), 490 B.R. 470, 477–78 (S.D.N.Y.2013) (discussing whether a secured lender was entitled to adequate protection during the pendency of the case); [In re Erehon, Inc.](#), 21 B.R. 79, 84 (Bankr.D.Mass.1982) (stating that a secured creditor worried about diminution in value need only object to use of collateral “since the burden of proving adequate protection is substantially that of the **Debtor**”); [Hamilton Bank v. Diaconx Corp. \(In re Diaconx Corp.\)](#), 69 B.R. 333, 338 (Bankr.E.D.Pa.1987) (denying use of cash collateral because **debtor** failed to carry burden of showing that secured lender's interest “would be adequately protected”). As the Court already explained, the parties already agreed that the JSNs' interest in their collateral would be adequately protected when they signed the Cash Collateral Order.
- 32 See [In re Walck](#), No. 11–37706(MER), 2012 WL 2918492, at *2 (Bankr.D.Colo. Jul. 17, 2012) (in the context of a motion for relief from stay, construing [section 506\(a\)](#) in light of [Rash](#), finding that secured creditor was adequately protected based on the fair market value of collateral projected to be earned by sale); [Bank R.I. v. Pawtuxet Valley Prescription & Surgical Ctr.](#), 386 B.R. 1, 4 (D.R.I.2008) (holding that going concern/fair market value could be used where secured lender objected to finding that it was adequately protected); [In re Eskim LLC](#), No. 08–509, 2008 WL 4093574, at *2–4 (Bankr.N.D.W.Va. Aug. 28, 2008) (in the context of motion for relief from stay, temporarily permitting **debtor** to use collateral to bridge to a going concern sale, and finding secured creditor might be adequately protected given that “the court's accepted valuation of the property depends on its being sold at a going concern value—not one of foreclosure”); [In re Pelham Enters., Inc.](#), 376 B.R. 684, 690–93 (Bankr.N.D.Ill.2007) (in the context of a motion for relief from stay, construing [section 506\(a\)](#) in light of [Rash](#) and rejecting estimated liquidation value of collateral in the hands of creditor given undisputed evidence that the collateral was actually being used as part of **debtor's** going concern); [In re Deep River Warehouse, Inc.](#), No. 04–52749, 2005 WL 1287987, at *7–8 (Bankr.M.D.N.C. Mar. 14, 2005) (construing section 506(a) in the context of a motion for relief from stay, and finding secured creditor to be adequately protected based on real property's going concern value in light of **debtor's** proposal to retain property as a going concern); [In re Davis](#), 215 B.R. 824, 825–26 (Bankr.N.D.Tex.1997) (construing section 506(a) in the adequate protection context in light of [Rash](#), and holding that secured creditor in chapter 13 case was adequately protected based on the car's fair market value as of the petition date when **debtor** intended to retain and use the collateral); [In re Savannah Gardens–Oaktree](#), 146 B.R. 306, 308–10 (Bankr.S.D.Ga.1992) (adopting going concern valuation where collateral was to be retained and used under **chapter 11 plan**, in order to determine amount of secured claim under 506(a) and evaluate whether claim would be adequately protected by value of collateral); [In re Kids Stop of Am., Inc.](#), 64 B.R. 397, 401–02 (Bankr.M.D.Fla.1986) (construing section 506(a) in the adequate protection context, and concluding that secured creditor was entitled to continue receiving adequate protection payments because the collateral as of petition date was worth the amount actually realized from asset sales during the case); [Bank Hapoalim B.M. v. E.L.I., Ltd.](#), 42 B.R. 376, 379 (N.D.Ill.1984) (in context of motion for relief from stay, affirming bankruptcy court's utilization of an executed sale contract for valuation of sold collateral under [section 506\(a\)](#) to determine whether the secured creditor was adequately protected); [First Trust Union Bank v. Automatic Voting Mach. Corp. \(In re Automatic Voting Machine Corp.\)](#), 26 B.R. 970, 972 (Bankr.W.D.N.Y.1983) (for purposes of determining whether secured creditor was adequately protected on motion for relief from stay, rejecting evidence of liquidation value and holding that going concern methodology is appropriate when collateral is to be retained and used).
- 33 See [In re Scotia Dev., LLC](#), No. 07–20027, slip op. at 23–24 (Bankr.S.D.Tex. July 7, 2008) (“With non-cash property, the interest that secured creditor has a right to is the right to foreclose. Therefore, the case law suggests that the appropriate value to protect is the foreclosure value of the property and not the fair market value of the property.”), *aff'd in part*, [In re SCOPAC](#), 624 F.3d 274, 285–86 (5th Cir.2010); [In re Ralar Distribs., Inc.](#), 166 B.R. 3, 7 (Bankr.D.Mass.1994) (“The value relevant for adequate protection purposes, however, is not book value. It is liquidation value realizable by

- the creditor.”), *aff’d*, 182 B.R. 81 (D.Mass.1995), *aff’d*, 69 F.3d 1200 (1st Cir.1995); *Sharon Steel Corp. v. Citibank, N.A. (In re Sharon Steel Corp.)*, 159 B.R. 165, 169 (Bankr.W.D.Pa.1993) (using liquidation value for adequate protection purposes); *United States v. Case (In re Case)*, 115 B.R. 666, 670 (9th Cir. BAP 1990) (“If we were attempting to value FmHA’s interest in the property for adequate protection purposes, the possibility of forced liquidation would be assumed and a deduction for selling costs would be logical.”); *La Jolla Mortg. Fund v. Rancho El Cajon Assocs.*, 18 B.R. 283, 289 (Bankr.S.D.Cal.1982) (“In this regard, we must evaluate the collateral, being the adequate protection, in the hands of the claim holder. It is the creditors’ expected costs to liquidate the property that is relevant, not those of the debtor.”).
- 34 The Nationstar APA states clearly that the purchased assets are “Related to the Business.” (PX 33 at 38.) Related to the Business is defined in the Nationstar APA as “required for, held for, or used in the conduct of the Business.” (*Id.* at 30.) The Business described in the Nationstar APA is, broadly, the Debtors’ servicing and origination business. (*Id.* at 13, definition of “Business.”) In addition, the Nationstar APA specifically enumerates goodwill as a purchased asset. (*Id.* at 40.) Finally, in a provision requiring the Debtors to effect “Separation Services,” the Nationstar APA states that a stand-alone business was part of the bargain, and that “Sellers acknowledge and agree that Separation Services are intended to permit Sellers to deliver at Closing to the Purchaser the Business and Purchased Assets as a stand-alone business....” (*Id.* at 84.)
- 35 The Court notes that it was equally unimpressed with the testimony presented by Mr. Puntus on behalf of the Plaintiffs. But since the burden of proof lies with the Defendants, the shortcomings of Mr. Puntus’s methodology do not alter the result.
- 36 As Collier explains:
- However, often a secured party will consent to limited use of cash collateral to preserve the value of his interest in other collateral. Payment of expenses of preserving non-cash collateral, payroll expenses to keep the business operating and other immediate cash needs may be as important to a secured party early in the case as it is to the debtor in possession. 3 COLLIER ON BANKRUPTCY ¶ 363.03[4], at 363–34.
- 37 As a matter of statutory construction, the Defendants argue that while section 506 of the Bankruptcy Code—and indeed, the entire Bankruptcy Code—is written for a single debtor, section 102(7) of the Bankruptcy Code (the “Rules of Construction” section) explicitly provides that “the singular includes the plural.” 11 U.S.C. § 102(7). Thus, in multi-debtor cases, courts will treat Bankruptcy Code provisions that refer to a single debtor as referring to all debtors. *See, e.g., In re Vagi*, 351 B.R. 881, 885 (Bankr.N.D. Ohio 2006) (holding that, in a case involving co-debtors, under subsection 102(7), the phrase “acquired for the personal use of the debtor” in subsection 1325(a) “may also be read, ‘acquired for the personal use of the debtors’”). The Defendants contend therefore that section 506(a)(1) is properly read as follows: “an allowed claim of a creditor secured by lien[s] on property in which the estate[s] have an interest ... is a secured claim to the extent of the value of such creditor’s interest in the estate[s]’ interest in such property....” (Defendants’ Motion to Dismiss, ECF No. 13–01343 Doc. # 21–1 at 9.) The Court is unconvinced by either party’s statutory interpretation argument. Indeed, the statute seems silent on the issue at hand.
- 38 Another case cited by the Plaintiffs is equally unhelpful because it also deals with non-debtor entities. *See Official Comm. of Unsecured Creditors of Toy King Distribs., Inc. v. Liberty Sav. Bank (In re Toy King Distribs., Inc.)*, 256 B.R. 1, 187 (Bankr.M.D.Fla.2000) (“Although the collateral subject to [creditor’s] loan includes the property of the individual guarantors and property of the debtor, only the debtor’s property is relevant to the court’s determination of the secured status of [creditor’s] claim against the debtor under Section 506.”). The Defendants also argue out that even if *DeNofa’s* interpretation of subsection 506(b) is correct, it would not change the outcome here, because pursuant to section 102(7), “the singular includes the plural,” and the term “estate” must be interpreted as including all debtor “estates” holding collateral. Therefore, *DeNofa* could still be read to include all debtor estates in the section 506(b) calculation.
- 39 Other cases cited by the Defendants either involved substantively consolidated debtors or merely assumed, without discussing, that collateral could be aggregated across debtors. *See, e.g., In re Gen. Growth Props., Inc.*, No. 09–

- 11977(ALG), 2011 WL 2974305, *1 n.3 (Bankr.S.D.N.Y. July 20, 2011); *In re Capmark Fin. Grp., Inc.*, 438 B.R. 471, 490, 501 (Bankr.D.Del.2010); *In re Dana Corp.*, 367 B.R. 409, 412 (Bankr.S.D.N.Y.2007); *In re Urban Communicators PCS Ltd. P'ship*, 379 B.R. 232, 244 (Bankr.S.D.N.Y.2007), *aff'd in part and rev'd in part on other grounds*, 394 B.R. 325 (S.D.N.Y.2008); *In re Fiberglass Indus., Inc.*, 74 B.R. 738, 740 (Bankr.N.D.N.Y.1987).
- 40 While the court reached this conclusion in the context of a **plan** that provided for limited **substantive consolidation** under section 1123(a)(5)(C), the court seemingly reached its conclusion independently, rejecting the **debtor's** argument “particularly in view of the provisions of [the] **Plan**.” *SW Hotel Venture*, 460 B.R. at 33.
- 41 “Subsidiary” is defined in the JSN Indenture as “any corporation, partnership, limited liability company, association or other entity of which at least majority of the outstanding stock or other interest having by its terms ordinary voting power to elect majority of the board of directors, managers or trustees of such corporation, partnership, limited liability company, association or other entity (irrespective of whether or not at the time stock or other interest of any other class or classes of such Person shall have or might have voting power by reason of the happening of any contingency) is at the time owned by the Company, or owned by one or more Subsidiaries, or owned by the Company and one or more Subsidiaries (it being understood that GMAC Bank is not Subsidiary).” (PX 1 at 24.) “Significant Subsidiary” is defined in the JSN Indenture as any Subsidiary that met certain threshold conditions respecting the income or proportionate share of the total assets of the Company and Subsidiaries on a consolidated basis. (*Id.*)
- 42 Here, the Court distinguishes between allocation and calculation. As the Court already held in connection with the Ocwen APA, any purchase price allocation in the Berkshire APA was for tax purposes only. (PX 31 at 30.) This is distinct from the calculations relied upon here, which set out actual formulas for determining the amount Berkshire would eventually pay for different categories of loans.
- 43 As explained in Mr. Taylor's report, Ocwen engaged a third-party valuation expert (Applied Economics) to appraise the fair value of certain assets. (DX ABH; DX ST.) Applied Economics considered the ResCap software to be worth \$1.295 million (DX ST at 3), and that figure served as a portion of the “premises and equipment” allocation in Ocwen's 10–Q reporting on the ResCap sale.
- 44 This total does not include the \$25 million of BMMZ assets that JSNs claim a lien on and that were subject to an earlier motion to dismiss.
- 45 The Court already dismissed the Committee's attempt to recharacterize the BMMZ assets as **Debtor** assets. *Residential Capital*, 495 B.R. at 261. In its opinion, the Court rejected the Committee's contention that the BMMZ collateral was pledged to a bilateral facility as of the Petition Date. In fact, the **Debtors** did not own the BMMZ collateral on the Petition Date.
- 46 The Reacquired Mortgage Loans are distinct from the \$910 million of loans in the AFI LOC.
- 47 Account Nos. xxxx7286, xxxx3803, xxxx6323, xxxx9917, xxxx9454, xxxx4806, xxxx2482, xxxx2540, xxxx2565, xxxx2573, xxxx1781, xxxx1799, and xxxx1718. (Plaintiffs' Proposed Findings of Fact ECF Doc. # 187 at ¶ 293.)
- 48 The “Adjusted Preference Assets” asserted by the Plaintiffs do NOT include the following assets identified on Schedule 6 of the Committee Action: (1) 18 loans identified as “HFS Revolver” or “HFS Blanket,” with a net book value of \$1,950,188.00, (2) two REO properties identified as “HFS Blanket,” with a net book value of \$50,478.00, (3) three mortgage loans that were refinanced (the “Refinanced Mortgages”), with a net book value of \$1,021,096.00, and (4) certain REO properties that Mr. Landy acknowledges were “never transferred to or for the benefit of the [Noteholders] during the preference period,” with a net book value of \$12,106,073.00. (Landy ¶ 57; DX ABN at 12; DX AIS at 4; PX 127.)
- 49 The Committee used a reduced preference period from February 29, 2012 through the Petition Date (75 days instead of 90) (the “Modified Preference Period”). (ECF Doc. # 97.)
- 50 A preconfirmation **debtor**-in-possession has the power to initiate and prosecute preference actions. *See* 11 U.S.C. § 1107.
- 51 The Court reiterates comments made during closing arguments that it has serious problems with the methodology employed by Mr. Puntus in his valuation.
- 52 This finding is not a final decision whether the JSNs are oversecured or undersecured. Issues relating to certain other alleged JSN collateral were reserved for Phase II of the trial.

In re Residential Capital, LLC, 501 B.R. 549 (2013)

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In re TerreStar Networks, Inc., 457 B.R. 254 (2011)

55 Bankr.Ct.Dec. 96



KeyCite Yellow Flag - Negative Treatment

Declined to Extend by In re Circle 10 Restaurant, LLC, Bankr.D.N.J., November 7, 2014

457 B.R. 254

United States Bankruptcy Court,
S.D. New York.

In re TERRESTAR NETWORKS,
INC., et al., Debtors.
Sprint Nextel Corporation, and Official
Committee of Unsecured Creditors
of TerreStar Networks, Inc., et al.,
Plaintiff, and Plaintiff–Intervenor,
v.
U.S. Bank National Association, in
its capacity as Indenture Trustee
and Collateral Agent for the 15.0%
Senior Secured Payment–In–Kind
Notes due 2014, AD Hoc Group of
Noteholders of 15% Secured Notes,
and Terrestar Networks, Inc., et al.,
Defendant, and Defendant–Intervenors.

Bankruptcy No. 10–15446 (SHL).

|
Adversary No. 10–05461.|
Aug. 19, 2011.**Synopsis**

Background: Wireless telecommunications carrier, as unsecured creditor, brought adversary proceeding in Chapter 11 case of debtor-mobile satellite services provider and jointly administered debtors, challenging validity and priority, in relation to its reimbursement claim, of lien held by senior secured noteholders respecting debtor's broadcast license issued by Federal Communications Commission (FCC). Parties cross-moved for partial summary judgment.

Holdings: The Bankruptcy Court, Sean H. Lane, J., held that:

[1] noteholders had valid lien on economic value associated with license;

[2] noteholders' lien on license's economic value attached prepetition, and therefore honoring lien did not violate prohibition against liens on property acquired postpetition;

[3] application of “equities of the case” doctrine, so as to limit extent to which noteholders' security interest in economic value of license reached postpetition proceeds, was not restricted to circumstances in which license assets appreciated in value through use of unencumbered estate assets; and

[4] subordination of lien to carrier's reimbursement claim was not warranted.

Motions granted in part and denied in part.

West Headnotes (10)

[1] **Telecommunications** 🗝️ Public interest, convenience or necessity in general

To grant license for use of public airwaves or approve license transfer, Federal Communications Commission (FCC) must determine that transfer will serve the public interest; thus, the right to use the airwaves is a public right granted by the FCC to a licensee that may not be assigned without express FCC permission. Communications Act of 1934, § 310(d), 47 U.S.C.A. § 310(d).

3 Cases that cite this headnote

[2] **Telecommunications** 🗝️ Security interest in station; rights of creditors

Although lien cannot exist on broadcast license issued by Federal Communications Commission (FCC), security interest may attach to economic value of FCC license.

3 Cases that cite this headnote

- [3] **Secured Transactions** ➡ Title or interest of debtor

Secured Transactions ➡ Property Included

Secured Transactions ➡ Secured party's rights in proceeds

Telecommunications ➡ Licenses and permits

Senior secured noteholders had valid lien on economic value associated with broadcast license issued by Federal Communications Commission (FCC) to mobile satellite services provider under New York law, even if they could not hold lien on license itself, pursuant to security agreement granting noteholders right to receive monies, proceeds, or other consideration in connection with sale, assignment, transfer, or other disposition of any FCC licenses, proceeds from sale of any FCC licenses, or any goodwill or other intangible rights or benefits associated therewith.

3 Cases that cite this headnote

- [4] **Bankruptcy** ➡ Post-petition effect

Secured Transactions ➡ When security interest attaches

Telecommunications ➡ Licenses and permits

Senior secured noteholders' lien on economic value of broadcast license issued by Federal Communications Commission (FCC) to Chapter 11 debtor-mobile satellite services provider attached prepetition under New York law, even though there was no sale or transfer of underlying assets before debtor's bankruptcy case, and therefore honoring lien did not violate Bankruptcy Code's prohibition against liens on property acquired postpetition. 11 U.S.C.A. § 552.

- [5] **Bankruptcy** ➡ Post-petition effect

Even if Bankruptcy Code's prohibition on liens on property acquired postpetition applied to lien held by senior secured noteholders on economic value of broadcast license issued by Federal Communications Commission (FCC) to Chapter 11 debtor-mobile satellite services

provider, security agreement's broad grant of lien on economic value of FCC licenses, which went beyond proceeds to everything except license itself, triggered statutory exception allowing valid prepetition lien to extend to value generated postpetition by property subject to lien, where expressly provided for in security agreement. 11 U.S.C.A. § 552(a, b).

- [6] **Bankruptcy** ➡ Post-petition effect

As a general matter, Bankruptcy Code's "equities of the case" doctrine, which allows court to determine extent to which security interest in proceeds, products, offspring, or profits of prepetition property reaches postpetition proceeds, products, offspring, or profits, is intended to prevent secured creditors from receiving windfalls and to allow bankruptcy courts broad discretion in balancing interests of secured creditors against Code's general policy, which favors giving debtors a fresh start. 11 U.S.C.A. § 552(b)(1).

1 Cases that cite this headnote

- [7] **Bankruptcy** ➡ Post-petition effect

Bankruptcy court's authority to apply Bankruptcy Code's "equities of the case" doctrine, which permitted court to determine extent to which noteholders' security interest in economic value of Federal Communications Commission (FCC) license issued to Chapter 11 debtor-mobile satellite services provider would apply to postpetition proceeds, was not restricted to circumstances in which license assets appreciated in value through use of unencumbered estate assets. 11 U.S.C.A. § 552(b)(1).

- [8] **Bankruptcy** ➡ Equitable powers and principles

Bankruptcy court is a court of equity.

- [9] **Bankruptcy** ➡ Subordination

Federal Communications Commission (FCC) did not condition broadcast license issued to mobile satellite services provider upon provider's reimbursement of wireless telecommunications carrier for its costs in clearing bandwidth used by provider or otherwise determine priority of carrier's reimbursement claim in provider's Chapter 11 case, and therefore subordination, to carrier's reimbursement claim, of lien on economic value of license held by provider's secured noteholders was not warranted. 11 U.S.C.A. § 506(a)(1); N.Y.McKinney's Uniform Commercial Code § 9-203(b)(2).

[10] Secured Transactions 📁 Title or interest of debtor

New York's version of Uniform Commercial Code (UCC) allows secured parties no greater interest in collateral than the debtor itself holds. N.Y.McKinney's Uniform Commercial Code § 9-203(b)(2).

Attorneys and Law Firms

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MEMORANDUM OF DECISION

[SEAN H. LANE](#), Bankruptcy Judge.

Before the Court are cross motions for partial summary judgment in the above-captioned adversary proceeding filed by Sprint Nextel ("Sprint") in the Chapter 11 case of TerreStar Networks, Inc. ("TerreStar") *257 and the jointly administered debtors, Case No. 10-15446 (collectively, the "Debtors"). Debtor TerreStar is a mobile satellite services provider whose business requires a Federal Communications Commission ("FCC") license to use 20 MHz of a 2 GHz S-Band spectrum (the "S-Band License"). Pursuant to certain FCC declaratory rulings, Plaintiff Sprint filed claims against the Debtors in the amount of \$104 million for the Debtors' alleged share of Sprint's costs to clear the bandwidth that TerreStar now uses. To satisfy its admittedly unsecured obligation, Sprint asserts that a lien on TerreStar's license assets held by the 15% senior secured noteholders (the "Noteholders")—facially superior in priority to Sprint's claim—should either be (a) declared invalid; or (b) subordinated to Sprint's claim. The pending summary judgment motions all relate to the validity of the Noteholders' lien in relation to Sprint's claim.

Sprint's complaint has four counts, each alleging a different theory for its position. In Count I, Sprint maintains that the Noteholders' lien cannot attach to the S-Band License itself, and the lien is, therefore, invalid. Count II argues that even if the Noteholders' lien might be permissible as to the economic value associated with the license, the lien is not effective because (a) it could not attach under Article 9 of the New York Uniform Commercial Code (the "NYUCC") until after a sale of the license assets occurred; and (b) such lien is not permitted under [Bankruptcy Code Section 552](#), which prohibits liens on property acquired after the bankruptcy filing. Count III of Sprint's complaint argues that, assuming there is a valid lien on the S-Band License, the lien should be invalidated or subordinated to Sprint's claim for reimbursement under the [equities](#) of the [case](#) provision of [Bankruptcy Code Section 552\(b\)\(1\)](#). Finally, Count IV contends that the Noteholders' lien should be subordinated to Sprint's claim pursuant to [Bankruptcy Code Section 506\(a\)\(1\)](#) and Article 9 of the NYUCC because the FCC conditioned TerreStar's license upon reimbursement to Sprint for clearing the bandwidth that TerreStar now uses.

Sprint seeks summary judgment on Counts I, II, and IV. The Official Committee of Unsecured Creditors appointed in the Debtors' Chapter 11 cases (the "Committee") supports Sprint's motion on Counts I and II, but maintains that

the remaining counts are not ripe for summary judgment because discovery is incomplete. Defendant U.S. Bank, National Association (“U.S. Bank”), the indenture trustee and collateral agent for the Noteholders, opposes Sprint's motion and has cross moved for summary judgment on all four counts. An ad hoc committee representing the Noteholders in the Debtors' Chapter 11 cases joins U.S. Bank's motion on Counts I and II.

U.S. Bank and the Noteholders acknowledge the case law holding that a security interest may not be granted in an FCC license itself but argue that it is nonetheless well established that a lien may exist on the economic value of an FCC license. They maintain that the security agreement here grants a security interest in all economic value relating to TerreStar's S-Band License and that such a lien is not barred by Article 9 of the NYUCC or [Section 552 of the Bankruptcy Code](#).

For the reasons set forth below, the Court concludes that Defendants U.S. Bank and the Noteholders have a valid lien on the economic value of the S-Band License, and nothing in Article 9 of the NYUCC or [Section 552](#) invalidates this lien. Accordingly, the Court grants summary judgment to U.S. Bank and the Noteholders on Counts I and II, and denies summary judgment to Sprint and the Committee. As for Count III, the Court concludes that this equitable claim is fact *258 dependent and not ripe for summary judgment until after the completion of discovery. Finally, the Court declines to grant Sprint priority over the Noteholders' lien based on relevant FCC rulings and, therefore, denies Sprint's motion on Count IV while granting the motion of U.S. Bank.

BACKGROUND

The Debtors are providers of mobile satellite services (“MSS”), which require various licenses and authorizations from the FCC. Starting in the late 1990's, the FCC began assigning certain portions of spectrum (or “band”) for the use of MSS operators and their anticipated MSS systems. In June 2004, the FCC transferred a license to use 20 MHz of a 1990–2025 MHz spectrum, the S-Band License, to TerreStar.

On February 14, 2008, TerreStar issued \$500,000,000 in 15% Notes with a maturity date of 2014. Wholly-owned subsidiaries TerreStar National Services Inc. and TerreStar License Inc. served as guarantors of the 15% Notes. As noted above, the collateral agent and indenture trustee for the 15% Noteholders was U.S. Bank.

The Security Agreement for these 15% Notes was governed by the laws of New York and secured by:

[A]ll FCC License Rights ... including all FCC Licenses, including, without limitation, the *right to receive monies, proceeds, or other consideration in connection with the sale, assignment, transfer, or other disposition of any FCC Licenses, the proceeds from the sale of any FCC Licenses or any goodwill or other intangible rights or benefits associated therewith*, including without limitation all right of each Grantor to (A) transfer, assign or otherwise dispose of its rights, title and interests, if any, under or in respect of such FCC Licenses, (B) exercise any rights, demands and remedies against the lessor, licensor or other parties thereto, and (C) all rights of such Grantor to receive proceeds of any insurance, indemnities, warranties, guaranties or claims for damages in connection therewith....

Security Agreement [Dkt. No. 52, Exhibit C] § 3(f) (emphasis added).

The Security Agreement was, however, careful to carve out the FCC license itself from the lien:

[S]uch security interest does not include at any time any FCC License to the extent (but only to the extent) that at such time the Collateral Agent may not validly possess a security interest directly in the FCC License pursuant to applicable federal law, including the Communications Act of 1934, as amended, and the rules, regulations and policies promulgated thereunder, as in effect at such time, but such security interest does include at all times all proceeds of the FCC Licenses, and the right to receive all monies, consideration and proceeds derived from or in connection with the sale, assignment, transfer, or other disposition of the FCC Licenses....

Security Agreement [Dkt. No. 52, Exhibit C] § 3(f) (emphasis added). The Security Agreement also pledged as collateral all “General Intangibles,” as defined by Article 9 of the NYUCC. *Id.* at §§ 1.02, 3(a).

Consistent with the Security Agreement, the Offering Memorandum for the 15% Notes recognized that the lien does not cover the S-Band License itself because the FCC retains the authority to determine who may hold a license:

The ability of the collateral agent to foreclose on certain of the collateral securing the notes may be limited by U.S. ... laws and certain agreements. Current FCC policy prohibits the grant of a security interest in an FCC radio frequency

license or authorization.... As a result, even after we obtain our FCC *259 ... licenses, authorizations or approvals in principle, *holders of the notes will not have a direct security interest in these licenses and authorizations.* [An investor's] ability to foreclose on, or to exercise certain rights or remedies with respect to, certain of the collateral requires prior approval from the FCC to the extent it would result in an assignment or transfer of control of our FCC authorizations (whether as a matter of law or fact).

TerreStar Networks Inc. \$500,000,000 15% Senior Secured PIK Notes due 2014, Offering Memorandum [Dkt. No. 52, Exhibit A], at 42 (emphasis added). U.S. Bank perfected its security interest by filing a Uniform Commercial Code Financing Statement with the Delaware Secretary of State and the relevant agreements with the Securities and Exchange Commission.

The spectrum for which TerreStar holds the S-Band License was previously used for other purposes and was made available to TerreStar only after that bandwidth was cleared by Sprint, a wireless telecommunications carrier. Sprint relinquished its license to the 800 MHz spectrum in exchange for the license to the 1990–1995 MHz spectrum pursuant to an agreement with the FCC. *See Improving Public Safety Communication in the 800 MHz Band*, 19 FCC Rcd. 14969 ¶¶ 11–12 (2004) (the “800 MHz Order”). Before Sprint could operate in the 1990–1995 MHz spectrum, however, the FCC required Sprint to move the Broadcast Auxiliary Service (“BAS”) incumbents already occupying the 1950–2025 MHz spectrum. According to the FCC, Sprint's new license to the 1990–1995 MHz spectrum was worth \$2.801 billion more than the license to the 800 MHz spectrum. *See Improving Public Safety Communications in the 800 MHz Band*, 25 FCC Rcd. 13874 ¶ 7 n. 13 (2010) (citing 800 MHz Order ¶ 297; *Improving Public Safety Communications in the 800 MHz Band*, 19 FCC Rcd. 25120 ¶ 31 (2004)) (“The Commission valued the 1.9 GHz spectrum that Sprint is receiving as worth \$4.86 billion, and the spectrum Sprint is giving as worth \$2.059 billion.... [t]he difference [of which is] \$2.801 billion....”). In the 800 MHz Order, the FCC recognized that Sprint could either (a) credit move costs against Sprint's \$2.801 billion windfall; or (b) seek pro rata reimbursements from other MSS licensees who would subsequently occupy the cleared 1995–2025 MHz spectrum. *See* 800 MHz Order ¶¶ 261, 329–330. The FCC emphasized that Sprint was not entitled to “double dip” by receiving compensation from both MSS licensees and the FCC. *Improving Public Safety Communications in the 800 MHz Band*, 25 FCC Rcd. 13874 ¶ 6 (citing 800 MHz Order ¶¶ 261, 329–330). If Sprint failed

to obtain reimbursement from the relevant MSS licensees, however, Sprint will be entitled to credit from the FCC against any windfall.

Relatedly, the FCC issued an “Emerging Technologies” policy designed to prevent later licensees from receiving a free ride on prior spectrum clearing done by other licensees. That policy provided that “[a]ll MSS licensees who benefit from relocation of BAS are responsible for contributing, as a condition of their licenses.” Amendment of Section 2.106 of the Commission's Rules to Allocate Spectrum at 2 GHz for Use by the Mobile–Satellite Service, 15 FCC Rcd. 12315 ¶ 69 (2000) (the “2000 Ruling”). In the 2000 Ruling, the FCC used the term “condition” but did not address whether an MSS licensee would be stripped of its license if a licensee failed to honor its reimbursement obligations. *See id.* Motient Corporation, the predecessor company to TerreStar's parent company, recognized in its 2005 annual report that, as an MSS licensee, it could “have obligations to reimburse [Sprint] Nextel for certain of its band clearing costs.... [in a] range from \$0 to in excess of \$100 million.” Motient Corporation Form 10–K: For the *260 Fiscal Year Ended December 31, 2005 [Dkt. No. 40, Exhibit M], at 16.¹

With reimbursement obligations to Sprint remaining unpaid, Sprint filed suit against TerreStar and other MSS licensees in June 2008 in the United States District Court for the Eastern District of Virginia, seeking pro rata reimbursement of BAS relocation costs. *Sprint Nextel Corporation v. ICO Satellite Service G.P., et al.*, Civil Action No. 1:08–cv–651 (E.D. Va. 2008). At the MSS licensees' request, the district court held the case in abeyance and asked the FCC to clarify the BAS relocation cost sharing rules, including providing guidance on when an operator is considered to have entered the band and triggered a reimbursement obligation to Sprint. *Id.* at Dkt. No. 33.

In response to the district court's request, the FCC issued an order and report entitled *Improving Public Safety Communications in the 800 MHz Band*, 24 FCC Rcd. 7904 (2009) (the “2009 Ruling”). In the 2009 Ruling, the FCC “tentatively conclud[ed] that MSS operators ... will have an obligation to share, on a *pro rata* basis, in the costs associated with the relocation of BAS incumbents if they ‘enter the band’ prior to the BAS sunset date of December 9, 2013.” *Id.* ¶ 2 (emphasis in original). Notably, the 2009 Ruling used the term “obligation” rather than “condition” to describe the requirement of other MSS licensees to reimburse Sprint. *Id.*

On September 29, 2010, the FCC issued a declaratory ruling to provide additional guidance on FCC policy as to the Sprint reimbursement obligation. [Improving Public Safety Communications in the 800 MHz Band, 25 FCC Rcd. 13874 ¶ 1 \(2010\)](#) (the “2010 Declaratory Ruling”). In the 2010 Declaratory Ruling, the FCC found that MSS licensees have a reimbursement obligation to Sprint. *Id.* ¶ 6. More specifically, the FCC concluded that if an MSS licensee certifies that its satellite is operational before the sunset date of December 9, 2013, the MSS licensee becomes obligated to reimburse Sprint for its pro rata share of the relocation costs based on the amount of spectrum used. *Id.* ¶ 42. In so ruling, the FCC rejected the argument of TerreStar and fellow MSS licensee, New DBSD Satellite Services G.P. (“DBSD”), that Sprint’s delay in BAS relocation eliminated their reimbursement obligations. *Id.* ¶¶ 26–27. The FCC also responded to Sprint’s claim that an MSS licensee’s use of the license was conditioned on reimbursement:

Sprint Nextel argues that failure of an MSS entrant to pay its [BAS relocation] cost sharing obligation in a timely fashion should automatically result in the suspension of its right to operate and suspension of its license if the failure to pay continues.... We will adopt no specific policies or procedures as to how we should proceed if later new entrants fail to reimburse an earlier entrant for the cost of relocating BAS incumbents as required. Instead, we will address complaints regarding failure to make required payments that are filed before the Commission through our existing enforcement mechanisms.

Id. ¶ 73. As for liability between corporate affiliates, the FCC articulated its view that the reimbursement obligation should be viewed as going to the enterprise as a whole rather than only to the specified licensee. *Id.* ¶¶ 33–34 (citing, *inter alia*, [Gen. Tel. Co. of the S.W. v. United States](#), 449 F.2d 846, 854 (5th Cir.1971)).² Notwithstanding *261 the guidance provided on these issues, the FCC recognized that Sprint’s ultimate recovery against these MSS licensees “will be governed by the proceedings in the bankruptcy court, rather than by this Commission or in the district court case initiated by Sprint Nextel.” *Id.* ¶ 29.

Although scheduled to complete the BAS relocation by May 2007, Sprint actually did not complete the task until July 2010. Costs incurred for the relocation were submitted to a “Transition Administrator” to review for reasonableness, a process that remains ongoing.

TerreStar and its affiliates filed for Chapter 11 on October 19, 2010. Sprint filed proofs of claims for \$104 million against each of the Debtors for reimbursement costs relating to the BAS relocation. The Committee, comprised of six of TerreStar’s largest unsecured creditors, was appointed on October 29, 2010. Sprint commenced this adversary proceeding against U.S. Bank on December 17, 2010.

On July 7, 2011, TerreStar sold substantially all of its assets—including the S-Band License—to Gamma Acquisition L.L.C., an affiliate of Dish Network Corporation, for \$1.375 billion pursuant to [Section 363 of the Bankruptcy Code](#). Under the applicable sales agreement, TerreStar’s license transfer was subject to FCC approval. Under the Security Agreement, there is a \$1.5 billion obligation under the 15% Notes in principal, interest, and make-whole premiums.

DISCUSSION

A. SUMMARY JUDGMENT STANDARD

Summary judgment shall be granted where the movant demonstrates “that there is no genuine dispute as to any material fact and the movant is entitled to judgment as a matter of law.” [Fed.R.Civ.P. 56](#); *see also Celotex Corp. v. Catrett*, 477 U.S. 317, 322–26, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); [Mark IV Indus. v. N.M. Env’t. Dep’t \(In re Mark IV Indus.\)](#), 438 B.R. 460, 464–65 (Bankr.S.D.N.Y.2010). A material fact is one that “might affect the outcome of the suit under governing law.” [McCarthy v. Dun & Bradstreet Corp.](#), 482 F.3d 184, 202 (2d Cir.2007) (citation and internal quotation marks omitted). After the movant makes an initial showing that no evidence supports the nonmoving party’s case, that opposing party must come forward with competent evidence that a genuine issue of fact exists. *See Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 586–87, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). Mere conclusory allegations or unsupported speculations do not defeat a motion for summary judgment. *See id.* If the nonmoving party fails to establish the existence of an element essential to its case on which it will bear the burden of proof at trial, summary judgment is granted for the movant. [Celotex](#), 477 U.S. at 322–23, 106 S.Ct. 2548.

B. A VALID SECURITY INTEREST EXISTS IN THE ECONOMIC VALUE OF AN FCC LICENSE

[1] The Federal Communications Act of 1934, which governs licenses, originally contemplated only radio broadcasting but it now covers television and other modern

forms of mobile personal communication. See 47 U.S.C. § 151 *et seq.*; *Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 387–88, 89 S.Ct. 1794, 23 L.Ed.2d 371 (1969) (“[Maintaining orderly radio usage *262 and addressing] the chaos which ensued from permitting anyone to use any frequency at whatever power level he wished, ... made necessary the enactment of the ... Communications Act of 1934.”) (citations and footnotes omitted). Congress has granted the FCC the authority to regulate the use of the public airwaves in the United States, which includes the exclusive right to grant a license to use the airwaves and to approve any transfer of a license by a licensee. See 47 U.S.C. §§ 301, 310(d); see also 47 C.F.R. § 73.1150(a). In order to grant a license or approve its transfer, the FCC must determine that the transfer will serve the public interest; thus, the right to use the airwaves is a public right granted by the FCC to a licensee that may not be assigned without express FCC permission. See 47 U.S.C. § 310(d).

[2] To understand the arguments presented by the parties, it is necessary to briefly summarize the evolution of the law regarding whether, and to what extent, a lien may be placed on an FCC license or any value associated with it.³ The case law makes clear that, while a lien cannot exist on the license itself, a security interest may attach to the economic value of an FCC license.

Prior to 1992, the FCC took the position that a lien could not be placed on an FCC license in any manner:

[A] broadcast license, as distinguished from the station's plant or physical assets, is not an owned asset or vested property interest so as to be subject to a mortgage, lien, pledge, attachment, seizure, or similar property right.... [S]uch hypothecation endangers the independence of the licensee who is and who should be at all times responsible for and accountable to the Commission in the exercise of the broadcasting trust.

In re Ridgely Communications, Inc., 139 B.R. 374, 376 (Bankr.D.Md.1992) (citing *In re Merkley*, 94 F.C.C.2d 829, 830–31 (1983)) (internal quotation marks omitted).

In 1992, the question of whether a lien could be placed on an FCC license arose in two federal court cases that reached opposite conclusions. The first of these cases was *Ridgely Communications*. In *Ridgely*, the debtor, who owned and operated two commercial radio stations, granted its secured lender a first priority lien on all of its tangible and intangible property. *Ridgely*, 139 B.R. at 375. Following its Chapter 11

filing, the debtor sold its assets, including its FCC license, to third parties. *Id.* The secured lender demanded the sale proceeds, and the debtor objected by asserting that the lien was invalid as to the FCC license and resulting sale proceeds. *Id.* at 375–76. In siding with the secured lenders, the court in *Ridgely* distinguished *263 between a debtor's “private” right to receive economic value generated by its FCC license as opposed to the FCC's “public” right to assign FCC licenses.

Id. at 378–79.⁴ The court observed that the FCC's primary concern was “with preserving its regulatory authority over licensees and over the transfer of broadcast licenses.” *Id.* at 376 n. 1. Concluding that the perfection of the creditor's private right on the economic value of the license did not disrupt the FCC's public right to regulate the license, the court held that “a creditor may perfect a security interest in a debtor's F.C.C. broadcasting license, limited to the extent of the licensee's proprietary rights in the license vis-a-vis private third parties.” *Id.* at 379. The *Ridgely* court was careful to note that the security interest in the debtor's private right does not allow creditors to “initiate an involuntary transfer of the license to the creditor[] or to compel the initiation of a transfer or assignment of a license to a private third party. These are rights of the licensee vis-a-vis the F.C.C. and may not be abrogated by private agreement.” *Id.* The court further concluded that, under the UCC, the security interest was in a licensee's “general intangibles,” which may be perfected prepetition and prior to a sale of the license post-petition. *Id.*

The second case was *In re Tak Commc'ns, Inc.*, 138 B.R. 568 (W.D.Wis.1992), *aff'd*, 985 F.2d 916, 916–17 (7th Cir.1993), in which secured lenders held a lien on all of the debtor's tangible and intangible assets, including its FCC broadcasting licenses. After the debtor filed for Chapter 11, the lenders initiated an adversary proceeding to declare their liens valid. *Tak*, 985 F.2d at 916–17. In stark contrast to *Ridgely*, the *Tak* court held that the lien was invalid because the “FCC has consistently and unequivocally refused to recognize such interests,” citing a 1965 FCC ruling precluding creditors from holding a security interest in FCC licenses. *Id.* at 918 (citing *In re Twelve Seventy, Inc.*, 1 F.C.C.2d 965, 967 (1965) (“Credit cannot be extended in reliance upon the license as an asset from which the licensee's obligations may be satisfied....”)) (internal quotation marks omitted). The *Tak* court did, however, recognize that “[w]hether to permit such [security] interests is ... a matter for the FCC rather than the courts to decide.” *Id.* at 919.

To resolve the direct conflict between these two decisions, the FCC issued a declaratory ruling in 1994 that adopted *Ridgely*

and rejected *Tak*. In *re Cheskey*, 9 FCC Rcd. 986, 987 ¶ 9 n.8 (1994). In *Cheskey*, the FCC expressly embraced the public and private distinction articulated in *Ridgely*: “If a security interest holder were to foreclose on the collateral license, by operation of law, the license could transfer hands without the prior approval of the Commission. In contrast, giving a security interest in the proceeds of the sale of a license does not raise the same concerns.” *Id.* at 987 ¶ 8. Citing *Ridgely*, the FCC also referred to proceeds of a sale as the “licensee’s proprietary rights in the license vis-a-vis private third parties.” *Id.* at 987 ¶ 9 n.7. Noting the *Tak* court’s deference to FCC policy, the FCC in *Cheskey* explicitly concluded that “the court erred in *Tak* The court’s ruling cannot bind the Commission to a policy which it does not have.” *Id.* at 987 ¶ 9 n.8.

*264 Since the FCC’s issuance of *Cheskey*, it appears to be settled law that a creditor may perfect a lien in the private economic value of an FCC license to the extent that such lien does not violate the FCC’s public right to regulate license transfers. *MLQ Investors, L.P. v. Pacific Quadracasting*, 146 F.3d 746, 748 (9th Cir.1998) (adopting *Ridgely*’s public-private distinction and permitting a security interest in the private rights in an FCC license); *Urban Communicators PCS Ltd. P’shp v. Gabriel Capital, L.P.*, 394 B.R. 325, 334–35 (S.D.N.Y.2008) (same); *In re Ion Media Networks, Inc.*, 419 B.R. 585, 602 (Bankr.S.D.N.Y.2009) (“FCC Licenses ... are subject to an enforceable dedication of their economic value....”); *In re Beach Television Partners*, 38 F.3d 535, 537 (11th Cir.1994) (holding that “[a] security interest in the proceeds of an FCC-approved sale of a broadcast license in no manner interferes with the FCC’s authority and mandate under the Act to regulate the use of broadcast frequencies.”); *Wells Fargo Foothill, Inc. v. Kepler (In re Media Props.)*, 311 B.R. 244, 250 (Bankr.W.D.Wis.2004) (“After those prerogatives exclusive to the FCC are carved out, there remains an interest in the license which may be subjected to a security interest which would continue in proceeds of those interests by operation of law.”) (citation omitted); *In re Thomas Communications, Inc.*, 166 B.R. 846, 849 (S.D.W.Va.1994) (holding that “creditors in this case could possess a security interest in the proceeds from the sale of broadcast licenses issued by the FCC”); *State St. Bank and Trust Co. v. Arrow Commc’ns, Inc.*, 833 F.Supp. 41, 49 (D.Mass.1993) (holding that the creditors “secured interest in the general intangibles of [debtor’s broadcast stations], including the license, is superior to the unsecured interest ... when the proceeds are distributed.”); *PBR Communications Sys. v. Jefferson Bank (In re PBR Communications Sys.)*,

172 B.R. 132, 135 (Bankr.S.D.Fla.1994) (citation omitted) (stating that “*Ridgely* ... recognize[s] the validity of a security interest in a broadcast license [and] the enforceability of a security interest in the proceeds of an FCC approved sale.”); Clark & Clark, *The Law of Secured Transactions Under the Uniform Commercial Code* ¶ 2.04(3) (2010) (In *Cheskey*, “the FCC decided to modify its written policy to make clear that, although a security interest may not be taken in the sale of the license to an FCC-approved third-party, it may be taken in the proceeds of sale to an FCC-approved third party.”).⁵

Judge Peck of this Court addressed this topic in *Ion Media*. In that case, the plan of reorganization called for senior secured noteholders to exchange their notes—secured by the value of the debtors’ FCC licenses—for equity in the reorganized entity. See *Ion Media*, 419 B.R. at 593, 600. A junior creditor group commenced an adversary proceeding claiming that the liens on the licenses themselves were invalid and, therefore, that the licenses were unencumbered by the senior secured noteholders security interest. *Id.* at 602. In approving the plan, Judge Peck declared that the junior creditors’ argument was a “red herring” because the senior secured noteholders had contracted for a security interest in all the economic value of the FCC licenses to the extent allowed by law. *Id.* Judge Peck’s explanation echoed the *265 distinctions first set forth by the court in *Ridgely*: “It does not matter whether the FCC licenses are or are not subject to a valid lien, because they are subject to an enforceable dedication of their economic value to the First Lien Lenders.” *Id.* Judge Peck further clarified that there was no difference between a sale and a plan for purposes of the lien on the economic value of the licenses: “the Plan, predicated on a debt for equity exchange, is not generating sale proceeds in the sense that term is used, but is satisfied that in the context of asserting rights to the value of the FCC Licenses this is not a relevant distinction.” *Id.* at 600 n. 21.⁶

[3] Applying the reasoning of all these cases to the current dispute, this Court concludes that the Noteholders have a valid lien on the economic value associated with TerreStar’s S-Band License, even if they cannot hold a lien on the FCC license itself. The Security Agreement here gives the broadest grant possible over the right to receive economic value from an FCC License: “the right to receive monies, proceeds, or other consideration in connection with the sale, assignment, transfer, or other disposition of any FCC Licenses, the proceeds from the sale of any FCC Licenses or any goodwill or other intangible rights or benefits associated therewith....” Security Agreement [Dkt. No. 52, Exhibit C] § 3(f).⁷ Despite this broad grant on the economic value of the license, the

lien in this Security Agreement is consistent with the FCC's public regulatory role recognized in *Cheskey* and its progeny because it "does not include at any time any FCC License to the extent (but only to the extent) that at such time the Collateral Agent may not validly possess a security interest directly in the FCC License pursuant to applicable federal law...." *Id.* § 3(f); see also *Ion Media*, 419 B.R. at 602.

Sprint relies upon the Offering Memorandum circulated to potential investors in *266 the Senior Secured Notes as evidence that U.S. Bank and the Noteholders knew they did not have a security interest in the S-Band License. However, Sprint overlooks the fact that the Offering Memorandum limits the lien to the economic value of the license and explicitly carves out any lien on the license itself:

[H]olders of the notes will not have a direct security interest in these licenses and authorizations. [An investor's] ability to foreclose on, or exercise certain rights or remedies with respect to, certain of the collateral requires prior approval from the FCC to the extent it would result in an assignment or transfer of control of our FCC authorizations (whether as a matter of law or fact).

Offering Memorandum [Dkt. No. 52, Exhibit A], at 42. Thus, the language of the Offering Memorandum simply mirrors the position taken by U.S. Bank and the Noteholders in the current dispute before this Court, namely, that the Security Agreement created a valid lien on the economic value of TerreStar's S-Band License but not on the license itself.

C. THE LIEN ON THE ECONOMIC VALUE OF AN FCC LICENSE ATTACHED PREPETITION AND IS NOT BARRED BY SECTION 552 OF THE BANKRUPTCY CODE

[4] Relying heavily on a decision from the bankruptcy court in Colorado, *Spectrum Scan LLC v. Valley Bank & Trust Co. (In re Tracy Broad. Corp.)*, 438 B.R. 323 (Bankr.D.Colo.2010), appeal docketed, No. 10-CV-02522 (D. Colo., Oct. 15, 2010), Sprint contends that the Noteholders' lien is invalid under Article 9 of the NYUCC and Bankruptcy Code Section 552. Specifically, Sprint claims that the Noteholders' lien did not attach because there was no sale or transfer of the underlying assets before the bankruptcy, and thus honoring the lien would violate Section 552's prohibition against liens on property acquired after the commencement of the bankruptcy case. This Court rejects these arguments as contrary to the clear weight of authority and inconsistent with the well-established policy of permitting liens on the economic value of FCC licenses.

Other than the decision in *Tracy*, courts have uniformly recognized that an FCC license is a general intangible and that a lien on such an intangible may be perfected prepetition before any proceeds or other consideration is generated and prior to any transfer, sale, or other disposition of the license. *MLQ*, 146 F.3d at 749; *Urban Communicators*, 394 B.R. at 335; *Media Properties*, 311 B.R. at 247. The Committee asserts that these decisions are inapplicable to the case at hand, but the Court rejects the Committee's overly narrow reading of these cases.

In *MLQ*, a lender secured by the proceeds of an FCC license filed suit against a defaulting debtor and guarantor to seek sale of the license and to obtain the resulting proceeds. *MLQ*, 146 F.3d at 747. Prior to the commencement of that suit, but after perfection of that lender's security interest, the IRS filed a lien on the same FCC license for unpaid taxes. *Id.* The debtor maintained that the lender's lien on the proceeds was invalid since it could not be perfected until after proceeds were generated, whereas the IRS lien existed before the post-petition sale for proceeds occurred. *Id.* at 749.

The Ninth Circuit disagreed. It held that a lender may perfect a security interest in the proceeds of an FCC license and that such interest may be perfected prior to sale of the license. *Id.* Invoking *Ridgely*, the *MLQ* court relied upon the distinction between the private right to grant liens on the economic value of an FCC license and the public right to regulate the license itself. *Id.* The *MLQ* court also *267 found that under the UCC, government licenses are "general intangibles" or "personal property interests in which security interests may be perfected," *id.* (citing *Ridgely*, 139 B.R. at 379), and are distinguishable from a security interest in after-acquired property under the Uniform Commercial Code, *id.* at 749 n.

1.⁸ The Ninth Circuit concluded that:

[There is] no reason why the proceeds should not be considered 'general intangibles,' therefore subject to perfection prior to sale. Indeed, a contrary outcome would mean that the distinction between private and public interests in FCC license proceeds, outlined in *In re Ridgely* and *In re Cheskey*, would have no meaning, and the private interests would be devoid of value. A security interest in proceeds that could not be perfected until after foreclosure and sale of the license would, in almost every circumstance, be primed by IRS liens and claims of other creditors. The fact that in the present case the actual dollar proceeds from

the sale of the licenses were generated only after the sale—and thus after the tax lien filing, as well-is immaterial. ‘[N]early all forms of security must be reduced to cash before they pay off the debt secured thereby.’

Id. at 749 (citing Peter F. Coogan, *Tax Liens and the UCC*, 81 Harv. L. Rev. 1369, 1385 (1968)). The court in *MLQ* considered and rejected the *Tak* decision, noting that it was based upon the FCC's prior position that liens on broadcast licenses were impermissible, a view that the FCC had subsequently and explicitly rejected. *Id.* at 748.

In *Urban Communicators*, the Southern District of New York followed *MLQ* in concluding that liens on FCC licenses attach and may be perfected prepetition. 394 B.R. at 334–35 (affirming holding of the bankruptcy court). In that case, a lender sought the sale proceeds from an FCC license, and the debtor objected. *Id.* at 332. The relevant security agreement provided that:

to the extent the Holding Company may be prohibited from granting a security interest in the FCC Licenses pursuant to the Communications Act or the rules and regulations of the FCC this security interest shall not encumber the FCC Licenses as opposed to the proceeds that may be derived therefrom.

Id. at 328 (internal quotation marks omitted). Like *MLQ*, the debtor argued that the lien was on sale proceeds from the licenses and could attach only after the license yielded proceeds. *Id.* at 334. The district court in *Urban Communicators* rejected this argument and adopted the *MLQ* public-private distinction to validate the lien on proceeds—or economic value—of the license. *Id.* at 334–35. It echoed the Ninth Circuit's decision in *MLQ* that “a creditor may perfect a security interest in a borrower's FCC broadcasting license to the extent that the creditor seeks to protect its interest in the proceeds of the borrower's license.” *Id.* at 334. Also following *268 *MLQ*, the court found the lien on proceeds from the FCC license to be on a “general intangible” and that it attached when the security interest was created.⁹ See *id.* at 334–35 (acknowledging the *MLQ* court's conclusion that “the licensee's rights in the license proceeds includ [e] a limited right to pledge those proceeds as collateral”).¹⁰

Similarly, the *Media Properties* court held that a prepetition security interest in an FCC license validly extended to all attributes of the license not specifically reserved to the FCC. In re *Media Properties, Inc.*, 311 B.R. 244, 249–50 (Bankr.W.D.Wis.2004). In that case, a lender asserted a first priority lien in the sale proceeds of an FCC license. *Id.* at 246. The security agreement there pledged “all of the

tangible and intangible personal property and fixtures of the Debtor ... and excepting only any FCC License of Debtor to the extent that a Lien thereon would cause or permit the revocation or loss of such FCC License....” *Id.* The trustee argued that (1) the lender's security interest was only in the prepetition proceeds, but none existed; and (2) the sale proceeds were after-acquired property under Section 552 in which the creditor could not perfect an interest. *Id.* In rejecting those arguments, the court in *Media Properties* concluded that the lien covered all private attributes of the license not explicitly reserved to the FCC:

It seems clear that since [*Tak*,] the FCC and the courts considering the issue have found the glass to be at least half full. A creditor can ... take a security interest in all rights of the licensee against third parties, which is more than just proceeds of a sale. After those prerogatives exclusive to the FCC are carved out, there remains an interest in the license which may be subjected to a security interest which could continue in proceeds of those interests by operation of law. UCC Section 9–203(g). Thus, when the license is sold, the existing security is liquidated. Such a security interest avoids the effects of 11 U.S.C. § 552.

Id. at 249–50. Thus, the court reasoned that although there were no proceeds when the lien was granted, the proceeds were generated from sale of a general intangible in which the creditor had a prepetition interest.¹¹

*269 Against the backdrop of this authority, Sprint relies upon *Tracy Broadcasting*, 438 B.R. at 328–31, in which the court invalidated a lien on the proceeds of an FCC license. In *Tracy*, an unsecured creditor sought a judgment declaring that a secured lender's lien on general intangibles did not attach to the post-petition proceeds of the debtor's FCC license. *Id.* at 325. The *Tracy* court held that the debtor did not have rights in the FCC license itself, and thus could not grant an enforceable prepetition security pursuant to UCC § 9–203. The Court further concluded that, because no lien may be placed on the license itself, Section 552 barred the secured creditor from asserting its security interest in the proceeds of an FCC license post-petition. *Id.* at 330–31.

The *Tracy* decision is, however, problematic. As a threshold matter, the *Tracy* court reached its conclusion based on the faulty assumption that “there has been no definitive ruling from the FCC itself, and there are Circuit Court cases which seem to reject any security interest in any aspect of an FCC License.” *Id.* at 328. For this proposition, the court in *Tracy* cites *Tak*, which *Cheskey* explicitly rejected as inconsistent

with FCC policy and which the Ninth Circuit rejected in *MLQ*. The other case relied upon by the *Tracy* court is a 1933 decision from the Ninth Circuit, *see id.* at 330 (citing *Sims v. Jamison*, 67 F.2d 409, 411 (9th Cir.1933) (addressing validity of purported security interest in crops not yet planted)), the same Circuit Court of Appeals that explicitly rejected this result in *MLQ*. Indeed, the *Sims* decision was issued before “general intangibles” was added as a category of collateral under the UCC. *See* 8 *Hawklund UCC Series* § 9–106:1 (Reuters 2010 ed.) (describing history of “general intangibles” in relation to the UCC).¹²

[5] Thus, the *Tracy* decision is fundamentally at odds with the case law set forth above that permits liens on the economic value of an FCC license. It ignores the sound reasoning of the court in *Ridgely*, which recognized the distinction between the public and private rights associated with an FCC license. By ignoring that distinction, the reasoning in *Tracy* would place two problematic conditions on the attachment of a lien against the economic value of a broadcast license—a sale and FCC approval—that would make it difficult, if not impossible, for such a lien to survive the filing of a bankruptcy, notwithstanding the wealth of authority that such liens are permissible and the FCC’s conclusion that such liens are desirable.¹³ As recognized in the decisions in *MLQ*, *Urban Communicators*, *Media Properties* and others, the arguments made by Sprint, if accepted, would unsettle expectations by invalidating such liens in the bankruptcy context or permitting all other creditors to *270 come before the liens, thus severely diminishing or eliminating their value.¹⁴

D. REMAINING COUNTS OF THE COMPLAINT

Counts III and IV of Sprint’s complaint offer two additional legal theories to challenge the priority of the Noteholders’ lien. U.S. Bank seeks summary judgment on both counts, whereas Sprint seeks summary judgment only on Count IV.

[6] In Count III, Sprint asserts that the FCC could not have issued the S–Band License to TerreStar but for Sprint’s relocation of the BAS incumbents pursuant to the 800 MHz Order. Given that Sprint conferred the benefit upon TerreStar before the Noteholders secured their lien on TerreStar’s S–Band License, Sprint claims that the lien should be invalidated or subordinated to Sprint’s reimbursement claim under Section 552(b)(1)’s “equities of the case” doctrine. Section 552(b)(1) provides that:

[I]f the debtor ... entered into a security agreement before the commencement of the case and if the security interest ... extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case ..., *except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.*

11 U.S.C. § 552(b)(1) (emphasis added). As a general matter, the “equities of the case” provision is intended to prevent secured creditors from receiving windfalls and to allow bankruptcy courts broad discretion in balancing the interests of secured creditors against the general policy of the Bankruptcy Code, which favors giving debtors a fresh start.” *In re Patio & Porch Sys. Inc.*, 194 B.R. 569, 575 (Bankr.D.Md.1996) (citations and internal quotation marks omitted).

[7] U.S. Bank concedes that the factual record is incomplete on Count III. *See* U.S. Bank’s Memorandum of Law in Opposition to Plaintiffs’ Motions for Summary Judgment and in Support of Its Cross Motion for Summary Judgment [Dkt. No. 55], at 25 (“Plaintiffs have not moved for summary judgment on [Count III] because questions of equity are fact intensive and the parties are in the early stages of discovery in this case.”). U.S. Bank nonetheless seeks summary judgment based on a narrow legal argument, namely that the equities of the case doctrine applies only where a secured creditor’s collateral has appreciated in value through the use of unencumbered assets from the debtors’ estates. *Id.* (citing, *inter alia*, *In re Bennett Funding Group, Inc.*, 255 B.R. 616, 634 (N.D.N.Y.2000) (observing that the primary rationale for this doctrine is “to prevent a secured creditor from reaping benefits from collateral that has appreciated in *271 value as a result of the [debtor’s] use of [unencumbered assets].”)). As its collateral did not increase in value because of the use of unencumbered estate assets, U.S. Bank contends that the equities of the case doctrine cannot apply regardless of the facts revealed in discovery. Sprint disagrees, arguing that the “equities of the case” doctrine is “exceptionally broad” and not limited to the narrow parameters U.S. Bank has identified.

[8] “The bankruptcy court is a court of equity. ‘Equity’ has been defined as the spirit and habit of fairness, justness, and right dealing that should regulate the affairs of individuals.” *Jaecksch v. GMAC (In re Jaecksch)*, 2007 WL 7141220, at *1–2, 2007 Bankr.LEXIS 1829, at *5–6 (Bankr.N.D. Ga.

April 4, 2007) (citation omitted). The phrase “**equities** of the **case**” is not defined in the Bankruptcy Code. *In re Compass Marine Corp.*, 1992 Bankr.LEXIS 1680, at *6 (Bankr.E.D.Pa. Oct. 28, 1992). Despite the seemingly broad grant given by Section 552(b)(1)’s language, this Court has described the “**equities** of the **case**” doctrine in fairly narrow terms. Most recently, this Court explained:

The **equities** of the **case** doctrine is intended to ensure that secured creditors do not receive a windfall benefit when a trustee uses assets of the estate, for example, to finish uncompleted inventory, and it is also used to adjust recovery by a secured creditor in situations where there is an improvement or decline in the post-petition collateral, especially in situations where the change in value is brought about by a party in the bankruptcy.

In re Barbara K Enters., 2008 WL 2439649, at *11, 2008 Bankr.LEXIS 1917, at *32–33 (Bankr.S.D.N.Y. June 16, 2008) (citations omitted). Similarly, in *In re Photo Promotion Associates, Inc.*, 61 B.R. 936 (Bankr.S.D.N.Y.1986), this Court observed that “[t]he equity exception is meant for the case where the trustee or debtor in possession uses other assets of the bankrupt estate (assets that would otherwise go to the general creditors) to increase the value of the collateral.” *Photo Promotion Assocs.*, 61 B.R. at 939 (quoting *J. Catton Farms, Inc. v. First National Bank of Chicago*, 779 F.2d 1242, 1246 (7th Cir.1985)) (internal quotation marks omitted).

Other courts have similarly described the narrow contours of the **equities** of the **case** doctrine. See *In re Cross Baking Co.*, 818 F.2d 1027, 1033 (1st Cir.1987) (“[S]ection 552(b) is designed to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors, but is limited to the benefit inuring to the secured party thereby.”) (citation omitted); *Toso v. Bank of Stockton (In re Toso)*, 2007 WL 7540985, at *12–13, 2007 Bankr.LEXIS 4889, at *41–43 (B.A.P. 9th Cir. Jan. 10, 2007) (“**Equities** of the **case**, as that phrase is used in § 552(b)(1), is anything but vague.... [T]he **cases** interpreting the **equities** of the **case** exception make clear its principal purpose is to prevent secured creditors from reaping unjust benefits from an increase in the value of collateral during a bankruptcy case resulting from the debtor’s use of other assets of the estate, or from the investment of non-estate assets.... No circuit case law attributes a different meaning to this phrase.”) (internal quotation marks omitted); *All Points Capital Corp. v. Laurel Hill Paper Co. (In re Laurel Hill Paper Co.)*, 393 B.R. 89, 93 (Bankr.M.D.N.C.2008) (“The cases involving section 552(b)(1) appear to place the

most weight on whether a debtor expended unencumbered funds of the estate, at the expense of the unsecured creditors, to enhance the *272 value of the collateral.”) (citations omitted); *In re S & Z International Management, Inc.*, 10 B.R. 580, 582 n. 1 (Bankr.S.D.Fla.1981) (“Subsection 552(b), does provide that the court, ‘based on the **equities** of the **case**’, may order ‘otherwise’, but the legislative history indicates that this is to make provision for an increase in the value of collateral created by the estate at the estate’s expense, and which thus depletes the fund available for general unsecured creditors.”).

Notwithstanding the narrow circumstances described by these decisions, some cases have observed that the doctrine *might* have broader application. *In re 680 Fifth Ave. Assocs.*, 154 B.R. 38, 41 (Bankr.S.D.N.Y.1993) (“[T]here is no one scenario to which application of the equities doctrine is limited. Rather, the examples provided by the courts and treatises are but a few of what surely can be deemed a non-exhaustive list. The theme that rings true to all of the examples, however, is that the exception offers a bankruptcy court, essentially a court of equity, considerable latitude in balancing the rights of competing creditor entities with the overall rehabilitative scheme of bankruptcy law.... [W]hile I may choose not to exercise that discretion, the Code vests me with the authority to do that which the debtors have requested.”) (citation omitted); see also *Patio & Porch Sys.*, 194 B.R. at 575 (“552(b) grants the court broad equitable powers in determining the extent of the security interest Creditor may be allowed to maintain postpetition.”); *In re Mullen*, 172 B.R. 473, 479 (Bankr.D.Mass.1994) (“As demonstrated by the statements on the floor of both branches, Congress was concerned about the situation where the estate spends money and thereby causes an enhancement in proceeds or rents which improves the position of the secured party. It had foremost in mind the conversion of raw materials to inventory or inventory to accounts. But Congress obviously did not wish to limit the exception to those circumstances. The standard for application of the exception—the **equities** of the **case**—gives the court the broadest possible charter.”) (footnote omitted); *In re Cardinal Indus.*, 118 B.R. 971, 981 (Bankr.S.D.Ohio 1990) (“The legislative history to that section indicates that ‘**equities** of the **case**’ includes the situation where application of a pre-petition security interest to post-petition rents would be unfair to unsecured creditors because expenditures would be required of the estate to preserve the secured creditor’s collateral or improve its position.... As enacted, the provision may be even broader than the version commented upon in the legislative history cited.”) (citations omitted); *In re Trans-*

Texas Petroleum Corp., 33 B.R. 67, 69 (Bankr.N.D.Tex.1983) (“**552(b)** grants this court discretion, on equitable grounds, to modify or alter the security interest defined by state law.”) (citation omitted).

Applying these principles to the case at hand, the Court refuses to limit the doctrine, as a matter of law, as requested by U.S. Bank. To be sure, the facts as described in these motions do not appear to fall within the contours of the doctrine as most commonly understood.¹⁵ But the Court is mindful that the factual record in this case is not yet fully developed and ***273** that the plain language of **Section 552(b)** is not limited to the specific factual scenario set forth by U.S. Bank. Accordingly, the Court denies U.S. Bank's motion for summary judgment on Count III as premature. See *Indergit v. Rite Aid Corp.*, 2010 WL 1327242, at *7–8, 2010 U.S. Dist. LEXIS 32322, at *20–21 (S.D.N.Y. March 31, 2010) (“[T]he incomplete nature of the record, and the parties' factual disputes ..., make it improper for this Court—at this time—to resolve Plaintiff's claims as a matter of law.”); *Park Ave. Bank, N.A. v. T.C. Ziraat Bankasi*, 1995 WL 739514, at *1, 1995 U.S. Dist. LEXIS 18433, at *3 (S.D.N.Y. Dec. 13, 1995) (“Summary judgment is strongly disfavored prior to the parties having had an adequate opportunity for discovery.”).

[9] [10] In seeking summary judgment on Count IV, Sprint asserts that the Noteholders' lien should be subordinated to Sprint's reimbursement claim by virtue of Article 9 of the NYUCC and **Section 506 of the Bankruptcy Code**. At first blush, neither section appears to provide for the remedy that Sprint seeks. The NYUCC allows secured parties no greater interest in collateral than the debtor itself holds. See *N.Y. U.C.C. LAW § 9–203(b)(2)*. Similarly, **Section 506** provides only that “a secured claim [is secured] to the extent of the value of such creditor's interest in the estate's interest in such property....” **11 U.S.C. § 506(a)(1)**. Both sections address the extent to which an interest is secured, and neither mentions the subordination of liens.

Rather than rely on the text of these two provisions, Sprint's argument instead depends upon Sprint's contention that the Debtors' interest in the license—the collateral for the Noteholders' lien—was created subject to Sprint's reimbursement claim. Citing relevant FCC rulings, Sprint asserts that the S–Band License's existence is a prerequisite to any encumbrance on the value of such license. Most notably, Sprint cites the 2000 Ruling, which provides that use of the S–Band License is expressly conditioned on reimbursement to Sprint for clearing the bandwidth: “Subsequently entering

MSS licensees ... will, as a condition of their licenses, compensate the first entrant on a pro rata basis, according to the amount of spectrum the subsequently entering licensees are authorized to use.” Memorandum of Law in Support of Plaintiff Sprint Nextel Corporation's Motion for Partial Summary Judgment [Dkt. No. 39], at 33 n.12 (citing 2000 Ruling, ¶ 71).¹⁶

***274** Sprint's argument is, however, defective in at least two ways. First, the 2000 Ruling used the term “conditional” but has never explicitly conditioned use of the S–Band License on payment of full pro rata reimbursement to Sprint. Indeed, the FCC's subsequent 2009 Ruling stated that MSS licensees, including TerreStar, have a reimbursement “obligation” to Sprint, not that use of the S–Band License was conditioned on full pro rata reimbursement to Sprint. See 2009 Ruling, ¶ 2. When revisiting the issue again in its 2010 Declaratory Ruling, the FCC refused Sprint's request to make full reimbursement a condition for use of the license:

Sprint Nextel argues that failure of an MSS entrant to pay its [BAS] cost sharing obligation in a timely fashion should automatically result in the suspension of its right to operate and suspension of its license if the failure to pay continues.... We will adopt no specific policies or procedures as to how we should proceed if later new entrants fail to reimburse an earlier entrant for the cost of relocating BAS incumbents as required. Instead, we will address complaints regarding failure to make required payments that are filed before the Commission through our existing enforcement mechanisms.

2010 Declaratory Ruling, ¶ 73. If the FCC wished to expressly condition TerreStar's use of the license on full reimbursement, the FCC had several opportunities to do so. It did not.

Second, Sprint's argument ignores that it is the role of the Bankruptcy Court, not the FCC, to determine the priority of Sprint's claim vis-à-vis other parties' claims. As the FCC specifically stated in the 2010 Declaratory Ruling: “the actions we take here are not an adjudication of the claims that Sprint Nextel, DBSD, and TerreStar have raised in that court proceeding.” *Id.* ¶ 82. The FCC recognized, instead, that Sprint's recovery for any reimbursement obligation “will be governed by the proceedings in the bankruptcy court, rather than by this Commission or in the district court case initiated by Sprint Nextel.” *Id.* ¶ 29. The FCC further explained that “any proceedings by Sprint Nextel on a claim for monetary recovery against a debtor in [a bankruptcy proceeding] ... is a matter for the Bankruptcy Court and is not addressed in

this Report and Order and Declaratory Ruling.” *Id.* at ¶ 79.¹⁷ Indeed, the FCC noted that it is “not seek[ing] to determine the pecuniary interest of any individual debtor or creditor.” *Id.* There can be no dispute then that the FCC did not intend to determine the priority of Sprint’s reimbursement claim in this bankruptcy.

The FCC’s views on this subject are consistent with the Supreme Court’s view that the FCC’s role as regulator of the telecommunications industry is distinct *275 from the bankruptcy court’s role as arbiter of claims disputes in bankruptcy. See *FCC v. NextWave Personal Commc’ns*, 537 U.S. 293, 302–04, 123 S.Ct. 832, 154 L.Ed.2d 863 (2003). In *NextWave*, the Supreme Court held that the Bankruptcy Code prohibited the FCC from revoking a debtor’s license based upon the debtor’s failure to make payments to the FCC for the purchase of the license, even though such payment was an explicit condition of the license. *Id.* at 303–04, 123 S.Ct. 832. The FCC had argued that “regulatory conditions ... are not properly classified as debts under the Bankruptcy Code,” and that the “respondent’s obligations are not dischargeable in bankruptcy because it is beyond the jurisdictional authority of bankruptcy courts to alter or modify regulatory obligations.” *NextWave*, 537 U.S. at 302–03, 123 S.Ct. 832 (citations and internal quotation marks omitted). The Supreme Court disagreed, explaining that:

Under the Bankruptcy Code, ‘debt’ means ‘liability on a claim,’ ... and ‘claim,’ in turn, includes any ‘right to payment,’ We have said that ‘claim’ has ‘the broadest available definition,’ ... and have held that the ‘plain meaning of a ‘right to payment’ is nothing more nor less than an enforceable obligation, regardless of the objectives the State seeks to serve in imposing the obligation,’ In short, a debt is a debt, even when the obligation to pay it is also a regulatory condition.

NextWave, 537 U.S. at 302–03, 123 S.Ct. 832 (citations omitted). The Supreme Court further observed that “where Congress has intended to provide regulatory exceptions to provisions of the Bankruptcy Code, it has done so clearly and expressly”; thus, “[a] preconfirmation debt is dischargeable unless it falls within an express exception to discharge.” *NextWave*, 537 U.S. at 302–03, 123 S.Ct. 832.

Relatedly, Sprint asserts that public policy favors granting its motion on Count IV because recognizing the Noteholders’

lien would interfere with regulation of FCC licenses. Memorandum of Law in Support of Plaintiff Sprint Nextel Corporation’s Motion for Partial Summary Judgment [Dkt. No. 39], at 33 (citing *MLQ*, 146 F.3d at 748; *Tak*, 985 F.2d at 918–19). But the FCC has not made such an argument in this proceeding. Moreover, one could argue that Sprint’s position may be inconsistent with the FCC’s efforts to encourage, as a matter of public policy, the ability of licensees to obtain secured financing. See *In the Matter of Facilitating the Provision of Spectrum-Based Services to Rural Areas, et al.*, 19 F.C.C. Rcd. 19078 ¶¶ 47–49 (2004) (“[I]n order ... to construct facilities and deploy innovative services to all Americans, ... licensees must have sufficient access to capital.... [T]he Commission ... [sought] comment on whether we could improve access to capital by allowing licensees to grant security interests to creditors.... [L]icensees may be able to maximize their efficient use of spectrum by leveraging the value of their retained spectrum usage rights to increase access to capital....”) (footnotes and internal quotations omitted); *In the Matter of Principles for Promoting the Efficient Use of Spectrum by Encouraging the Development of Secondary Markets*, 15 F.C.C. Rcd. 24178, ¶ 24 (2000) (“[To maximize] the efficient use of spectrum, ... [the FCC] consider[ed] ways licensees could leverage ... their retained spectrum usage rights to increase access to capital. Access to capital, especially for smaller businesses, affects the licensee’s ability to use its spectrum resources under its license.”).

CONCLUSION

For the reasons set forth above, the Court (1) denies Sprint’s request for summary judgment on Counts I, II and IV; (2) denies the Committee’s request for summary judgment on Counts I and II; (3) *276 grants the Noteholders’ request for summary judgment on Counts I and II; (4) grants the request of U.S. Bank for summary judgment on Counts I, II and IV; and (5) finds that Count III is not yet ripe for summary judgment. Defendants should settle an order on three days’ notice.

All Citations

457 B.R. 254, 55 Bankr.Ct.Dec. 96

Footnotes

- 1 TerreStar's parent company, TerreStar Corporation, is the successor company to Motient Corporation.
- 2 The FCC's comments about enterprise liability were directed to DBSD and its affiliated companies, which had filed for bankruptcy in the Southern District of New York. The question of enterprise liability as applied to TerreStar and its affiliates is the subject of separate motions in this case.
- 3 It is unclear whether Sprint maintains that no lien of any kind is permissible on the value associated with an FCC license, or simply that the lien here is impermissible under the circumstances presented in this case:
THE COURT: Well, do you—are you telling me that the FCC policy is different than what I understand it to be, that you can have a lien on the economic value of the license?
MR. LADDIN: I don't think the FCC has—I don't believe that the FCC itself has actually decided that you can't have that language.
THE COURT: So you're saying the FCC policy is essentially open to debate, and I don't know what it is?
MR. LADDIN: At best. I mean, that's correct....
Transcript of Oral Argument, April 21, 2011 [Dkt. No. 68], at 71–72. There has been similar confusion regarding the scope of relief requested in Count I. The Court does not understand U.S. Bank or the Noteholders to seek to enforce the lien against the license itself. *See, e.g.*, Ad Hoc Reply at 3 (“[N]o party can take an interest in an FCC license superior to the ‘public’ right held by the FCC itself.”) Accordingly, this Court construes Count I as seeking a declaration that U.S. Bank and the Noteholders are not entitled to obtain any value based upon the lien in the Security Agreement.
- 4 In its decision, the *Ridgely* court took note of an FCC decision in *In re Bill Welch*, 3 FCC Rcd. 6502 (1988), which recognized a licensee's proprietary interest, however limited, in its license. *Ridgely*, 139 B.R. at 376–77. The *Ridgely* court also relied upon a decision from this Court, *Shimer v. Fugazy (In re Fugazy Express)*, 114 B.R. 865, 873 (Bankr.S.D.N.Y.1990), *aff'd* 124 B.R. 426 (S.D.N.Y.1991), which concluded that a broadcast licensee possessed proprietary rights in the license, notwithstanding that the license was subject to a regulatory scheme. *Ridgely*, 139 B.R. at 377.
- 5 Notably, Sprint characterizes *Ridgely*, *MLQ*, and the decisions in this District that rely upon them — *Urban Communicators* and *Ion Media*—as “outmoded and largely inapplicable.” Combined Reply Brief in Support of Plaintiff Sprint Nextel Corporation's Motion for Partial Summary Judgment and Response in Opposition to Defendants' Cross-Motions for Summary Judgment [Dkt. No. 58], at 2. This Court disagrees.
- 6 Sprint's motion papers distinguish between a reorganization and a sale, arguing there would be no proceeds generated for which a purported lien could attach if a reorganization occurred. *See* Memorandum of Law in Support of Sprint Nextel Corporation's Motion for Summary Judgment [Dkt. No. 39], at 21–22. This Court explicitly rejected such a distinction in *Ion Media*. In any event, such a distinction is now irrelevant given that, subsequent to the filing of Sprint's motion papers, the debtors conducted a Section 363 sale of their assets which yielded proceeds of \$1.375 billion. *See* Order (A) Approving Asset Purchase Agreement and Authorizing the Sale of Assets of Debtor Outside the Ordinary Course of Business; (B) Authorizing the Sale of Assets Free and Clear of All Liens, Claims, Interests and Encumbrances; (C) Authorizing the Assumption and Sale and Assignment of Certain Executory Contracts and Unexpired Leases; and (D) Granting Related Relief, Case No. 10–15446–SHL, dated July 7, 2011 [Dkt. No. 668], at 1, 9–10.
- 7 The Security Agreement here is notably similar to the agreement in *Ion Media*:
The plain language of the Transaction Documents specifies that the First Lien Lenders and the Second Lien Lenders expressly contracted in the Transaction Documents for separate security interests in all economic value of the FCC Licenses and in all non-monetary aspects of the FCC Licenses themselves to the extent allowed by law. *See* Security Agreement at § 2.1(f) (including FCC Licenses in definition of ‘Collateral’); § 5.7 (clarifying that the grant of security interest in the FCC Licenses is ‘to the extent that a security interest in such licenses is permitted under applicable law’). This grant of a security interest in the economic value of the FCC Licenses is further confirmed by the utilization of special purpose subsidiaries to hold the FCC Licenses, the concomitant pledges of the equity interests in each FCC License Subsidiary by the Debtors to the Secured Parties, and the Intercreditor Agreement's restrictions on Second Lien Lender actions.
Ion Media, 419 B.R. at 602.
- 8 *See also Ridgely*, 139 B.R. at 379 (citing, *inter alia*, *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 369 (9th Cir.1987) (distinguishing rights between government and licensee from rights between licensee and private third party and holding that Federal and state transportation operating authorities are “general intangibles”); *In re O'Neill's Shannon Village*, 750 F.2d 679, 682–83 (8th Cir.1984) (liquor license is “general intangible” under U.C.C. § 9–106); *First Pennsylvania Bank, N.A. v. Wildwood Clam, Inc.*, 535 F.Supp. 266, 268 (E.D.Pa.1982) (commercial clamming license is “general intangible”); *In re Genuario*, 109 B.R. 550 (Bankr.D.R.I.1989) (liquor license is “general intangible”); *In*

- re *Cleveland Freight Lines, Inc.*, 14 B.R. 777, 780 (Bankr.N.D.Ohio 1981) (certificate of public convenience and necessity is “general intangible” and security interest attaches to proceeds of sale of certificate)).
- 9 The Committee asserts that *Urban Communicators* addressed only “when” a lien may attach to the FCC license, not “whether” a lien may attach. See Memorandum of Law in Further Support of the Motion for Summary Judgment of Intervenor–Plaintiff, the Official Committee of Unsecured Creditors of TerreStar Networks, Inc., *et al.* and in Opposition to Defendants’ Cross–Motions for Summary Judgment [Dkt. No. 60], at 9. However, the decision in *Urban Communicators* addressed “when” a lien may attach by discussing “whether” a lien may attach when an FCC license is pledged as collateral pre-petition.
 - 10 Notably, Section 9–408 of the NYUCC “makes ineffective any attempt to restrict the assignment of a general intangible ... in a rule of law, including a statute or governmental rule or regulation.” See N.Y. U.C.C. LAW § 9–408, cmt.2.
 - 11 Sprint and the Committee argue that the lien must attach to prepetition proceeds and cannot be effective here because no such proceeds exist. See Combined Reply Brief in Support of Plaintiff Sprint Nextel Corporation’s Motion for Partial Summary Judgment and Response in Opposition to Defendants’ Cross–Motions [Dkt. No. 58], at 13–14; see also Memorandum of Law in Further support of the Motion for Summary Judgment of Intervenor–Plaintiff, the Official Committee of Unsecured Creditors of TerreStar Networks, Inc., *et al.* and in Opposition to Defendants’ Cross–Motions for Summary Judgment [Dkt. No. 60], at 11–12. Their position ignores that the Security Agreement here includes a broad grant in the economic interest of the S–Band License and general intangibles, not simply to proceeds. See Security Agreement § 3.
 - 12 Sprint argues that “this is an unusual case, in which an unsecured creditor (Sprint Nextel) ... has a direct claim against the special purpose subsidiary [TSL] ... that holds the Debtors’ FCC Licenses.... Following *Tracy Broadcasting* in this case thus should have no chilling effect whatsoever on the financing of FCC licensees as a general matter.” Combined Reply Brief in Support of Plaintiff Sprint Nextel Corporation’s Motion for Partial Summary Judgment and Response in Opposition to Defendants’ Cross–Motions [Dkt. No. 58], at 23. However, the reasoning of *Tracy* would invalidate liens on FCC licenses generally and not merely those where a special purpose subsidiary has been used.
 - 13 At oral argument, Sprint’s counsel asserted the holding of *Tracy* still allows a debtor to proceed with a prepackage reorganization where—before filing—the parties in interest first agree to transfer the license and then the debtor receives FCC approval for this arrangement. The narrow nature of this hypothetical demonstrates, however, the severe limitations on financing that would be imposed if the holding of *Tracy* were applied to all FCC license holders.
 - 14 As the discussion above makes clear, these three decisions are flatly inconsistent with Sprint’s contention that a lien on the value of an FCC license is an impermissible lien on after-acquired property under Section 552(a). But even assuming that Section 552(a)’s prohibition regarding liens on after-acquired property applied, which it does not, the lien would still be valid because it falls within the exception set forth in Section 552(b). Section 552(b) provides that a valid prepetition lien in property can extend to value generated by such property post-petition when expressly provided for in the security agreement. Consistent with this exception, Section 3 of the Security Agreement in this case gives a broad grant in the economic value of the FCC licenses beyond the proceeds to everything except the license itself and, therefore, the lien here is akin to the one found enforceable in *Media Properties*. See Security Agreement § 3; *Media Properties*, 311 B.R. at 249–50.
 - 15 Sprint’s obligation to clear the bandwidth existed before the Security Agreement, and Sprint cleared the bandwidth before the Debtors’ bankruptcy was filed. Plaintiff Sprint Nextel Corporation’s Statement of Material Facts as to Which There Is No Genuine Issue to Be Tried [Dkt. No. 40], at ¶¶ 13–14 (Security Agreement dated February 14, 2007); *Id.* at ¶ 23 (FCC obligated Sprint to relocate BAS incumbents in 2004 Public Safety Order); *Id.* at ¶ 41 (BAS relocation completed on July 15, 2010); *Id.* at ¶ 46 (Debtor filed under Chapter 11 on October 19, 2010). Thus, the factual record here is far different than in the handful of reported cases where parties have successfully invoked the equities of the case doctrine to alter the rights of a secured creditor. See *Toso*, 2007 Bankr. LEXIS 4889, at *40–46 (holding that where the debtor used unencumbered funds of the estate to grow and maintain his asparagus crop, “[t]he bankruptcy court did not abuse its discretion when it decided, under § 552(b)(1), that [creditor’s] security interest should not extend to Debtor’s 2005 and 2006 asparagus crop based upon the ‘equities of the case.’ ”); *Photo Promotion Assocs.*, 61 B.R. at 940 (“Based on the equities of the case [doctrine], the plaintiff’s security agreement does not extend to the proceeds ... from the sale of finished family portraits which were not in existence at the commencement of this case and which were thereafter produced ... as a result of the activities of the trustee in bankruptcy, who paid for the creation of the finished portraits with [unencumbered] funds from the estate.”); *In re Delbridge*, 61 B.R. 484, 490–91 (Bankr.E.D.Mich.1986) (applying the “equities of the case” doctrine and holding that based on the contribution of unencumbered assets and effort by the

debtor and his family, a secured creditor was “entitled to a lien on [only] 20% of proceeds of the sale of milk from the debtor’s post-petition operations.”).

- 16 U.S. Bank argues that Count IV is “nothing more than an equitable subordination claim based upon [Sprint’s] alleged efforts in clearing the bandwidth,” and thus is an equitable claim that is “inappropriate for summary judgment prior to the completion of discovery.” U.S. Bank’s Memorandum of Law in Opposition to Plaintiffs’ Motions for Summary Judgment and in Support of its Cross–Motion for Summary Judgment [Dkt. No. 55], at 29 (citing, *inter alia*, 11 U.S.C. § 510(c) (providing for equitable subordination)). In response, Sprint categorically denies that Count IV lies in equity: “In fact, and on its face, Count IV ... is an entirely legal cause of action based on a set of facts that is not disputed, and on established principles of UCC and bankruptcy law.” Combined Reply Brief in Support of Plaintiff Sprint Nextel Corporation’s Motion for Partial Summary Judgment and Response in Opposition to Defendant’s Cross–Motions for Summary Judgment [Dkt. No. 58], at 24 (citing 11 U.S.C. § 506(a)(1); N.Y. U.C.C. LAW § 9–203(b)(2)). Given Sprint’s position, the Court declines to consider Count IV as an equitable subordination claim and construes it as a legal argument premised upon NYUCC Article 9 and Code Section 506.
- 17 As the DBSD Chapter 11 bankruptcy also was ongoing at the time of the 2010 Declaratory Ruling, this Court also presumes that the FCC was aware that the priority of prepetition claims, such as Sprint’s reimbursement claim, was the subject of possible dispute. *See* 2010 Declaratory Ruling, ¶ 29.



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As of: February 22, 2022 11:55 PM Z

InteliQuest Media Corp. v. Miller (In re InteliQuest Media Corp.)

United States Bankruptcy Appellate Panel for the Tenth Circuit

June 6, 2005, Filed

BAP No. UT-04-059

Reporter

326 B.R. 825 *; 2005 Bankr. LEXIS 982 **; 44 Bankr. Ct. Dec. 233

IN RE INTELQUEST MEDIA CORPORATION, doing business as IMC, doing business as KIQN, doing business as KIQ AM 1010, doing business as DrMiser, doing business as InteliQuest, Debtor. IN RE

INTELQUEST LEARNING SYSTEMS, doing business as ILS, doing business as InteliQuest, Debtor.

INTELQUEST MEDIA CORPORATION, WOODBURY & KESLER, INTELQUEST LEARNING SYSTEMS, and COHNE RAPPAPORT & SEGAL, Appellants, v. GIL A. MILLER, Trustee and ZIONS FIRST NATIONAL BANK, Appellees.

Prior History: **[**1]** Appeal from the United States Bankruptcy Court for the District of Utah. Bankr. No. 02C-28588, Chapter 7, Bankr. No. 02C-31304, Chapter 7.

Core Terms

bankruptcy court, surcharge, collateral, Orders, res judicata, parties, administrative expense, expenses, financing, approve, motion to compel, post-petition

Case Summary**Procedural Posture**

Appellant debtors sought review of an order of the United States Bankruptcy Court for the District of Utah,

which denied, on the basis of res judicata, their motion to compel appellee trustee to seek a surcharge of appellee lender's collateral to pay their attorney's fees and expenses pursuant to [11 U.S.C.S. § 506\(c\)](#).

Overview

The bankruptcy court approved a post-petition financing stipulation with the lender by which the debtors waived [§ 506\(c\)](#) claims against secured parties. The bankruptcy court approved the trustee's stipulation that the lender satisfied the trustee's [§ 506\(c\)](#) claims for surcharges against the lender and its collateral. The debtors filed a motion to compel the trustee to prosecute a [§ 506\(c\)](#) claim for fees and costs against the lender's collateral. The court held that the bankruptcy court properly denied the motion on the ground that the debtors' waivers contained in previously-entered financing orders were res judicata. The court held that the waivers approved by the bankruptcy court, embodied in its orders, not appealed by the debtors, and raising the identical issues raised in their motion to compel were enforceable under res judicata as final orders. Allowing the trustee to disregard the orders to seek [§ 506\(c\)](#) treatment of the debtors' attorney's fees would have been a significant breach of faith with the lender. The court held that the bankruptcy court properly held that the res judicata barred the claim that [§ 506\(c\)](#) required a pro rata sharing of estate assets among claimants.

Outcome

The court affirmed the order of the bankruptcy court.

from final judgments, orders, and decrees of bankruptcy courts within the Tenth Circuit, unless one of the parties elects to have the district court hear the appeal. [28 U.S.C.S. § 158\(a\)\(1\)](#), [\(b\)\(1\)](#), and [\(c\)\(1\)](#); [Fed. R. Bankr. P. 8001](#); 10th Cir. Bankr. App. Panel R. 8001-1.

LexisNexis® Headnotes

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > Chargeable Expenses

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > General Overview

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > Claim Determinations

Civil Procedure > Appeals > Appellate

Jurisdiction > Final Judgment Rule

[HN3](#) Appellate Jurisdiction, Final Judgment Rule

A decision is considered final if it ends the litigation on the merits and leaves nothing for the court to do but execute the judgment.

[HN1](#) Secured Claims & Liens, Chargeable Expenses

See [11 U.S.C.S. § 506\(c\)](#).

Bankruptcy Law > ... > Judicial Review > Standards of Review > De Novo Standard of Review

Civil Procedure > Appeals > Standards of Review > De Novo Review

Bankruptcy Law > Procedural Matters > Judicial Review > Bankruptcy Appeals Procedures

Bankruptcy Law > Procedural Matters > Judicial Review > General Overview

Governments > Local Governments > Elections

[HN4](#) Standards of Review, De Novo Standard of Review

Bankruptcy Law > Procedural Matters > General Overview

Where the facts are not in dispute, the appellate panel reviews the bankruptcy court's legal conclusions de novo. When exercising de novo review, the appellate panel unconstrained by the trial court's conclusions, and may affirm the trial court on any legal ground supported by the record.

Bankruptcy Law > Procedural Matters > Judicial Review > General Overview

Bankruptcy Law > Procedural Matters > Judicial Review > Jurisdiction

[HN2](#) Judicial Review, Bankruptcy Appeals Procedures

The United States Bankruptcy Appellate Panel for the Tenth Circuit has jurisdiction to hear timely-filed appeals

Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

Civil Procedure > Judgments > Preclusion of

326 B.R. 825, *825; 2005 Bankr. LEXIS 982, **1

Judgments > General Overview

[HN5](#) **Preclusion of Judgments, Res Judicata**

Under res judicata, a final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised in that action.

Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

Civil Procedure > Judgments > Preclusion of Judgments > General Overview

[HN6](#) **Preclusion of Judgments, Res Judicata**

Court-approved settlements receive the same res judicata effect as litigated judgments.

Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

Civil Procedure > Judgments > Preclusion of Judgments > General Overview

[HN7](#) **Preclusion of Judgments, Res Judicata**

The elements of res judicata are (1) a final judgment on the merits in a prior action; (2) that the claims raised in the subsequent action are identical to those decided in the prior action; and (3) that the prior action involved the same parties or privies. This doctrine is intended to relieve parties of burdensome multiple lawsuits, to prevent inconsistent decisions, and to encourage reliance on adjudication.

Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

Civil Procedure > Judgments > Preclusion of Judgments > General Overview

[HN8](#) **Preclusion of Judgments, Res Judicata**

A waiver approved by the court and embodied in an order is enforceable under principles of res judicata.

Bankruptcy Law > ... > Unsecured Priority Claims > Administrative Expenses > Priority

Business & Corporate

Compliance > ... > Priorities > Creditor Priorities > Proceeds

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > General Overview

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > Chargeable Expenses

Bankruptcy Law > ... > Types of Claims > Secured Claims & Liens > Claim Determinations

Bankruptcy Law > ... > Unsecured Priority Claims > Administrative Expenses > General Overview

Bankruptcy Law > ... > Administrative Expenses > Priority > Professional Services

Civil Procedure > Judgments > Preclusion of Judgments > General Overview

Civil Procedure > Judgments > Preclusion of Judgments > Res Judicata

Contracts Law > Types of Commercial Transactions > Secured Transactions > General Overview

Contracts Law > ... > Secured

Transactions > Perfections & Priorities > General
Overview

Contracts Law > ... > Perfections &
Priorities > Priorities > General Overview

Administrative Expenses, Priority

Surcharges and administrative expenses under the Bankruptcy Code are distinct charges against estate property that serve very different purposes. Prorating one with another makes no conceptual sense and violates the Code's priority structure. Compensation for professionals is an administrative expense as defined in [11 U.S.C.S. § 503](#) and is an assessment against the estate as a whole because all of the creditors are benefitted. On the other hand, a surcharge under [11 U.S.C.S. § 506\(c\)](#) is not an administrative expense. It is an assessment against a secured party's collateral as reimbursement for a particular benefit to such a secured creditor. Unlike administrative expenses, a [§ 506\(c\)](#) surcharge does not come out of the debtor's estate, but rather comes directly from the secured party's recovery. Consequently, [§ 506\(c\)](#) expenses do not fall within the priority scheme of the Bankruptcy Code at all. These expenses are paid first out of the proceeds of the sale, before a secured creditor is paid.

Counsel: Russell S. Walker (David R. Williams and P. Corper James with him on the brief) of Woodbury & Kesler, P.C., Salt Lake City, Utah (Julie A. Bryan of Cohne Rappaport & Segal, Salt Lake City, Utah, with him on the brief) for Appellants.

Weston L. Harris of Parsons Kinghorn Harris, Salt Lake City, Utah, for Appellee Gil A. Miller.

Gary E. Jubber of Fabian & Clendin, Salt Lake City, Utah, for Appellee Zions First National Bank.

Judges: Before CORNISH, NUGENT, and BROWN, Bankruptcy Judges.

Opinion by: NUGENT

Opinion

[*826] NUGENT, Bankruptcy Judge.

Appellants appeal from an order of the United States Bankruptcy Court for the District of Utah enforcing two waivers of the right to seek attorney's fees and other expenses as surcharges against a secured party's collateral under [11 U.S.C. § 506\(c\)](#). The Bankruptcy Court concluded that the waivers, contained in previously-entered financing orders, were res judicata, and therefore binding. We affirm.

I. Background

Debtors IntelliQuest Media Corporation ("IMC") and IntelliQuest **[**2]** Learning Systems ("ILS") (collectively, the "Debtors" or "Appellants") filed a "joint" Chapter 11 Petition on May 24, 2002. By a minute order entered on July 10, 2002, the Debtors' cases were bifurcated. ¹ The bankruptcy court granted a motion to jointly administer the cases on September 18, 2002. Each Debtor has been represented by separate counsel throughout the proceedings.

On September 12, 2002, as debtors-in-possession, Debtors entered into a post-petition financing stipulation with appellee Zions First National Bank ("Zions") and another lender, American Investment Financial ("AIF") ² which provided:

[*827] As further adequate protection of Secured

¹ See Docket Sheet at 22, deemed included in Appellant's Appendix ("App.") by order dated October 7, 2004.

² AIF is not a party to this appeal.

Parties [Zions and AIF], and in consideration of Secured Parties' agreement to Emergency and Post-Petition Financing and Debtors' inclusion in the Budget of such amounts as Debtors deem necessary to preserve the collateral of Secured Parties, *Debtors* **[**3]** *hereby waive any and all claims which might now or hereafter exist against Secured Parties pursuant to [Section 506\(c\)](#) of the [Bankruptcy] Code.*³

On September 18, 2002, the bankruptcy court entered a preliminary order approving the Stipulation,⁴ and thereafter, on November 8, 2002, entered a final order approving same⁵ (collectively, the "2002 Orders"). Appellants did not appeal either of the 2002 Orders.

[4]** On February 18, 2003, the bankruptcy court appointed Gil A. Miller Chapter 11 Trustee ("Trustee") in both cases, displacing the debtors in possession.

On December 3, 2003, the Trustee and Zions ("Appellees") entered into and filed a stipulation concerning surcharging Zions' collateral for the Trustee's expenses incurred in its disposition.⁶ In this

stipulation, the parties agreed that the Trustee could seek further surcharges. The Trustee then filed a series of motions to sell assets and to recover administrative expenses incurred in the sale.⁷ **[**6]** On December 18, 2003, the cases were converted to Chapter 7. After conversion, Appellants and their counsel objected to the Trustee's application for administrative expenses and for surcharge on the basis that Appellants' counsel had yet to be compensated for their expenses that could also be surcharged under [§ 506\(c\)](#) and that, until all such administrative expense applications had been received, the bankruptcy court was precluded from allowing the Trustee's applications.⁸ By minute order dated January 8, 2004, the bankruptcy court granted Debtors' counsel an additional 15 days to file their applications for administrative expenses. **[**5]**⁹ On January 13, 2004, the bankruptcy court entered an order approving the December 3, 2003 stipulation and confirming the administrative bar date for Debtors' professionals (the "First [§ 506\(c\)](#) **[*828]** Order").¹⁰ By January 27, 2004,

Pursuant to [11 U.S.C. § 506\(c\)](#), in App. at 0055.

³ Stipulation Authorizing Debtor-In-Possession Financing and Granting Adequate Protection at 6, in Appellees' Supplemental Appendix ("Supp. App.") at S0041 (emphasis added). [HN1](#)  [11 U.S.C. § 506\(c\)](#) provides that "the trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."

⁴ See Order Approving Emergency Financing and Granting Adequate Protection at 3, in Supp. App. at S0030.

⁵ See Final Order Approving a stipulation Relating to Interim Financing Pursuant to [Section 364\(d\)](#) and Granting Priority Liens at 3, in App. at 0042.

⁶ See Stipulation for Recovery of Costs and Expenses

⁷ Motion for Order Approving Stipulation for Recovery of Costs and Expenses Pursuant to [11 U.S.C. § 506\(c\)](#) and Notice of Hearing Thereon, in App. at 0061; Omnibus (1) Motion to Allow and Approve Payment of Certain Administrative Expenses and (2) Objection to Allowance and Payment of Certain Other Asserted Administrative Expenses Combined with Notice of Hearing Thereon, in Supp. App. at S0159.

⁸ See Objection to Trustee's Motion to Allow and Approve Payment of Certain Administrative Expenses and Response to Objection for Allowance and Payment of Certain Other Asserted Administrative Expenses, in App. at 0067.

⁹ See Docket Sheet at 7, deemed included in App. by order dated October 7, 2004.

¹⁰ See Order with Respect to A) Motion for Order Approving Stipulation for Recovery of Costs and Expenses Pursuant to

both debtors' counsel had filed their applications. With respect to [§ 506\(c\)](#) surcharge, the First [§ 506\(c\)](#) Order stated:

The payment of such administrative expenses pursuant to [11 U.S.C. § 506\(c\)](#) is without prejudice to the Trustee seeking to charge Zions First National Bank pursuant to [11 U.S.C. § 506\(c\)](#) from remaining cash collateral of Zions National Bank [sic] presently held by the Trustee or directly to the extent remaining cash collateral may be inadequate.¹¹

On January 26, 2004, the Trustee and Zions filed another motion to approve a further stipulation between themselves in which they agreed:

The obligation of Zions set forth herein shall be in full and complete satisfaction of any and all [Section 506\(c\)](#) claims or charges that the Trustee, any successor trustee, or the estates of these Debtors shall have against Zions or its collateral.¹²

[**7]

Debtors' professionals objected to this motion.¹³ Debtors' objections again centered on their having

[11 U.S.C. § 506\(c\)](#) and B) Omnibus (1) Motion to Allow and Approve Payment of Certain Administrative Expenses and (2) Objection to Allowance and Payment of Certain Other Asserted Administrative Expenses, in App. at 0253.

¹¹ *Id.* at 0255.

¹² Motion for Order Approving Stipulation for Recovery of Costs and Expenses Pursuant to [11 U.S.C. § 506\(c\)](#) and Notice of Hearing Thereon at 7, in App. at 0282.

¹³ See Objection to Trustee's Motion for Order Approving Stipulation for Recovery of Costs and Expenses and to Allow and Approve Payment of Certain Administrative Expenses, in App. at 0289.

incurred expenses that would qualify as surcharges under [11 U.S.C. § 506\(c\)](#). After a hearing at which counsel for the Debtors, the Trustee, and Zions appeared, the bankruptcy court granted the Trustee's motion and approved the January 26, 2004 stipulation. After a February, 2004 hearing (at which time the bankruptcy court also approved fee applications previously filed by Debtors' counsel) the court approved Appellees' second [§ 506\(c\)](#) Motion.

[**8] In its order of March 9, 2004 ("the Second [§ 506\(c\)](#) Order"), the bankruptcy court approved the application for expenses set forth in the January 26, 2004 stipulation with a slight modification:

The obligation of Zions set forth herein shall be in full and complete satisfaction of any and all [Section 506\(c\)](#) claims or charges that the Trustee, his professionals or any successor trustee shall have against Zions or its collateral.¹⁴

Debtors appealed neither the First nor the Second [§ 506\(c\)](#) Order.

On March 1, 2004, before the entry of the Second [§ 506\(c\)](#) Order, both Debtors' counsel filed a joint motion to surcharge the remaining Zions cash collateral for their outstanding fees and expenses. This motion drew [**9] an objection from Zions, but was apparently never pursued.¹⁵ In May of 2004, Debtors filed a motion to

¹⁴ See Order Granting Motion for Order Approving Stipulation for Recovery of Costs and Expenses Pursuant to [11 U.S.C. § 506\(c\)](#) at 3, in App. at 0373. We note the bankruptcy court's removal of a reference to "the estate," see First [§ 506\(c\)](#) Order, *supra*.

¹⁵ Supreme Court authority makes it clear that only a trustee has standing to pursue a surcharge. See [Hartford Underwriters Ins. Co. v. Union Planters Bank](#), 530 U.S. 1, 6, 147 L. Ed. 2d 1, 120 S. Ct. 1942 (2000).

compel the Trustee "to prosecute a claim pursuant to [11 U.S.C. § 506\(c\)](#) for an order allowing attorney[']s [*829] fees and costs of debtors . . . to be assessed against [Zions'] collateral" ¹⁶ Both Appellees objected. ¹⁷ On June 17, 2004, after hearing argument from the parties, the bankruptcy court denied the Motion to Compel in its entirety.

[**10] On July 2, 2004, the bankruptcy court entered an order denying Debtors' Motion to Compel "as such relief is inconsistent with the [2002 Orders and the Second [§ 506\(c\)](#) Order] . . . all of which orders are final orders and are res judicata in this case" from which Debtors timely appealed. ¹⁸

II. Jurisdiction

[HN2](#) [↑] This Court has jurisdiction to hear timely-filed appeals from "final judgments, orders, and decrees" of bankruptcy courts within the Tenth Circuit, unless one of the parties elects to have the district court hear the appeal. ¹⁹ Neither party elected to have this appeal

¹⁶ See Motion to Compel Trustee to Pursue Claim Pursuant to [11 U.S.C. § 506\(c\)](#) and to Distribute Proceeds of Claim, in App. at 396-97.

¹⁷ See Objection of Zions First National Bank to Motion to Compel Trustee to Pursue Claim Pursuant to [11 U.S.C. § 506\(c\)](#) and to Distribute Proceeds of Claim, and Trustee's Response to Motion to Compel Trustee to Pursue Claim Pursuant to [11 U.S.C. § 506\(c\)](#) and to Distribute Proceeds of Claim, in App. at 396, 425.

¹⁸ See Order Denying Motion to Compel Trustee to Pursue Claim Pursuant to [11 U.S.C. § 506\(c\)](#) and to Distribute Proceeds of Claim, in App. at 0473.

¹⁹ [28 U.S.C. § 158\(a\)\(1\), \(b\)\(1\), and \(c\)\(1\)](#); [Fed. R. Bankr. P. 8001](#); 10th Cir. BAP L.R. 8001-1.

heard by the United States District Court for the District of Utah; thus each has consented to our review. [HN3](#) [↑] A decision is considered final "if it 'ends the litigation on the merits and leaves nothing for the court to do but execute the judgment.'" ²⁰ In [****11**] the present case, the order denying the Motion to Compel resolved all outstanding issues raised by Debtors' counsel. The matter is thus ripe for review.

III. Standard of Review

[HN4](#) [↑] As the facts are not in dispute, we review the bankruptcy court's legal conclusions *de novo*. ²¹ [****12**] When exercising *de novo* review, we are unconstrained by the trial court's conclusions, and may affirm the trial court on any legal ground supported by the record. ²²

IV. Discussion

Appellants challenge the bankruptcy court's refusal to compel the Trustee to seek a surcharge of Zions' collateral to pay their outstanding attorney's fees and expenses. They question the bankruptcy court's reliance upon res judicata. They also assert that relying on a previously-approved waiver of [§ 506\(c\)](#) surcharges to deny their motion violates public policy. Finally, they assert that their expenses are entitled to be treated pro-

²⁰ [Quackenbush v. Allstate Ins. Co.](#), 517 U.S. 706, 712, 135 L. Ed. 2d 1, 116 S. Ct. 1712 (1996) (quoting [Catlin v. United States](#), 324 U.S. 229, 233, 89 L. Ed. 911, 65 S. Ct. 631 (1945)).

²¹ [Nwosun v. General Mills Restaurants, Inc.](#), 124 F.3d 1255, 1257 (10th Cir. 1997) (citing [May v. Parker-Abbott Transfer & Storage, Inc.](#), 899 F.2d 1007, 1009 (10th Cir. 1990)).

²² See [Wolfgang v. Mid-America Motorsports, Inc.](#), 111 F.3d 1515, 1524 (10th Cir. 1997).

rata with the trustee's surcharges. While several courts have considered the effect of [§ 506\(c\)](#) waivers in financing orders, there are no reported decisions by courts in this Circuit.

[*830] In entering its order, the bankruptcy court relied exclusively on res judicata to deny not only the Appellants' motion to compel, but also their demand to be treated pro-rata with the trustee. [HNS](#)²³ "Under res judicata, a final judgment on the merits of an action precludes the parties or their privies from relitigating issues that were or could have been raised **[**13]** in that action." ²³ [HNS](#)²⁴ Court-approved settlements receive the same res judicata effect as litigated judgments. ²⁴ [HNZ](#)²⁵ The elements of res judicata are 1) a final judgment on the merits in a prior action; 2) that the claims raised in the subsequent action are identical to those decided in the prior action; and 3) that the prior action involved the same parties or privies. ²⁵ This doctrine is intended to relieve parties of burdensome multiple lawsuits, to prevent inconsistent decisions, and to encourage reliance on adjudication. ²⁶

Appellants' heavy reliance on *In re Hen* **[**14]** *House Interstate, Inc.* ²⁷ **[**15]** is misplaced. In that case (*Hen House I*), a panel of the Eighth Circuit held that in a

converted Chapter 11 case, an insurer of the debtor had standing to seek a [§ 506\(c\)](#) surcharge of a secured creditor's collateral to recover unpaid post-petition premiums. Notwithstanding the presence of a [§ 506\(c\)](#) waiver in a previously-entered financing order, the panel construed the lender's assent to the debtor's use of cash collateral as an implicit agreement to the insurer's surcharge and allowed the insurer to seek its surcharge. This opinion doubtless supports the Appellants' position, but it was vacated by the Eighth Circuit and resubmitted to that court *en banc* on the issue of whether the insurer had standing to seek the surcharge. ²⁸ In *Hen House II* ²⁹, the Eighth Circuit concluded that only the trustee has standing to pursue a surcharge. This view was ultimately affirmed by the Supreme Court in *Hartford Underwriters Insurance Co. v. Union Planters Bank*. ³⁰ *Hen House I* is therefore of no persuasive value in the case before us.

Only a few courts have dealt with the enforceability of a post-petition [§ 506\(c\)](#) waiver. One court has declined to approve such a waiver in the first instance. ³¹ **[**16]**

²³ [Allen v. McCurry](#), 449 U.S. 90, 94, 66 L. Ed. 2d 308, 101 S. Ct. 411 (1980) (citing [Cromwell v. County of Sac](#), 94 U.S. 351, 352, 24 L. Ed. 195 (1876)).

²⁴ [Bezanson v. Bayside Enterprises, Inc. \(In re Medomak Canning\)](#), 922 F.2d 895 (1st Cir. 1990), cited with approval in [Hoxworth v. Blinder](#), 74 F.3d 205 (10th Cir. 1996).

²⁵ [Hoxworth](#), 74 F.3d at 208.

²⁶ *Id.*

²⁷ [150 F.3d 868 \(8th Cir. 1998\)](#).

²⁸ [Id. at 873](#).

²⁹ [177 F.3d 719 \(8th Cir. 1999\)](#).

³⁰ [530 U.S. 1, 147 L. Ed. 2d 1, 120 S. Ct. 1942 \(2000\)](#).

³¹ See [In re Ridgeline Structures, Inc.](#), 154 B.R. 831, 832 (Bankr. D. N. H. 1993), where the bankruptcy court found that a stipulation purporting to waive [§ 506\(c\)](#) expenses "no matter what action, inaction, or acquiescence by [the secured party] might occur" (and which also failed to provide other creditors with the requisite objection period), was against public policy and unenforceable per se. The court warned that "[it] is not authorized to and never would insulate any party from the consequences of their conduct no matter how egregious." The *Ridgeline* court distinguished the matter before it from the case of [In re Film Equipment Rental Co.](#), 1991 WL 274464,

One District Court has, without **[*831]** addressing res judicata, found such a waiver to be unenforceable as interfering with the congressional mandate that the trustee have the authority to use a portion of a creditor's collateral to preserve or dispose of that collateral.³²

We consider that the better view of this issue is articulated in *In re Molten Metal Technology, Inc.*,³³ **[**17]** where the bankruptcy court held that [HNB](#) a waiver approved by the court and embodied in an order is enforceable under principles of res judicata. There, as here, the court approved such a waiver and made it a final order. *Molten Metal* states:

The issue is whether the order is now enforceable. On this the Lender correctly states the law: where the waiver is approved by and expressly embodied in an order of the Bankruptcy Court, then, by the principle of res judicata, it is enforceable - at least against the Debtors in Possession, the Trustee, and those served with the motions to approve the agreements containing the waivers - regardless of how it squares with public policy, with the Bankruptcy Code, and with the interests of the estate.³⁴

[1991 U.S. Dist. LEXIS 17956 \(S.D.N.Y. 1991\)](#), wherein a similar waiver was enforced, noting that in that prior case, there was no assertion of any egregious conduct which would render enforcement unconscionable. *Id.* n.2. There is no suggestion of "egregious conduct" here.

³² [McAlpine v. Comerica Bank-Detroit \(In re Brown Brothers, Inc.\)](#), 136 B.R. 470, 474 (W.D. Mich. 1991); *contra* [In re Molten Metal Tech., Inc.](#), 244 B.R. 515 (Bankr. D. Mass. 2000).

³³ [244 B.R. at 515](#).

³⁴ [Id. at 525](#). We note that the *Molten Metal* court cites with approval [Stoll v. Gottlieb](#), 305 U.S. 165, 83 L. Ed. 104, 59 S. Ct. 134 (1938), where a prior court order pertaining to subject-

Appellants do not argue that any of the [§ 506\(c\)](#) Orders entered in this case are not final. They never appealed either of the validly entered 2002 Orders or the First and Second [§ 506\(c\)](#) Orders. Both the estate and Trustee previously agreed that Zions' collateral would not be vulnerable to any surcharges other than those described in the orders. In hearings in which the Appellants actively participated, the bankruptcy court approved those agreements. The issues raised by Appellants in the Motion to Compel are identical to those raised in their Objections to each of the [§ 506\(c\)](#) Stipulations between the Trustee and Zions. No appeal from either of the [§ 506\(c\)](#) Orders was ever taken and indeed, the parties **[**18]** to each motion are identical. All three elements of res judicata are therefore present.

Furthermore, for the Trustee to have disregarded these binding Orders to seek [§ 506\(c\)](#) treatment of the Appellants' attorney's fees would not only breach the letter of the Orders but would also constitute a significant breach of faith with Zions. These kinds of agreements are among the building blocks upon which successful estate administration is based. If trustees were allowed to disregard these terms at the behest of debtors' professionals, what secured creditor would consider making either post-petition financing or cash collateral concessions to a debtor or a trustee? Holding otherwise would seriously undercut future efforts of debtors in possession or trustees to secure these concessions and hinder their ability to efficiently administer estate assets.

There are other avenues by which Appellants could have protected their attorney's fees; the collection of a prepetition retainer and securing a carve-out of the creditor's collateral being two commonly used methods.

matter jurisdiction was accorded preclusive effect within that case, vis-a-vis those parties, due to the compelling nature of the policies underpinning the res judicata doctrine.

As to Appellants' claim that [§ 506\(c\)](#) requires a pro rata sharing of [*832] estate assets among claimants, the bankruptcy court [**19] held that this claim was also barred by the res judicata effect of the First and Second [§ 506\(c\)](#) Orders. No [§ 506\(c\)](#) claims have been properly asserted on Appellants' behalf. We note that [HNG↑](#) surcharges and administrative expenses under the Bankruptcy Code are distinct charges against estate property that serve very different purposes. Prorating one with another makes no conceptual sense and violates the Code's priority structure. Compensation for professionals is an administrative expense as defined in [11 U.S.C. § 503](#) and is an assessment against the estate as a whole because all of the creditors are benefitted. On the other hand, a surcharge under [11 U.S.C. § 506\(c\)](#) is not an administrative expense. It is an assessment against a secured party's collateral as reimbursement for a particular benefit to such a secured creditor. As set forth in *In re Debbie Reynolds Hotel & Casino, Inc.*:³⁵

[Unlike administrative expenses, a [§ 506\(c\)](#) surcharge] does not come out of the debtor's estate, but rather comes directly from the secured party's recovery. Consequently, [§ 506\(c\)](#) expenses do not fall within the priority scheme of the Bankruptcy [**20] Code at all. These expenses "are paid first out of the proceeds of the sale, before a secured creditor is paid."³⁶

V. Conclusion

The bankruptcy court properly denied the Motion to Compel on the basis of res judicata. We AFFIRM.

³⁵ [255 F.3d 1061 \(9th Cir. 2001\)](#).

³⁶ *Id.* at 1067 (quoting [United States v. Federal Deposit Ins. Corp.](#), 899 F. Supp. 50, 55 (D. R.I. 1995)).

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Faculty

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James E. Millstein is the co-chairman of Guggenheim Securities, LLC in New York, the investment banking and capital markets business of Guggenheim Partners, a global investment and advisory firm. Prior to joining Guggenheim in 2018, he was the founder and CEO at Millstein & Co. His representative engagements at Guggenheim include advice to Fannie Mae in connection with its potential recapitalization, to Knighthead Capital and Certares Management in connection with their acquisition of Hertz out of chapter 11, and to the Governor of the State of California in connection with PG&E's chapter 11. His representative engagements at Millstein & Co. include advice to the Commonwealth of Puerto Rico in connection with the management of its \$75 billion of institutional indebtedness, to US Airways in connection with its acquisition of American Airlines out of chapter 11, and advice to Caesars in connection with its financial restructuring in chapter 11. From 2009-11, Mr. Millstein was the CRO at the U.S. Department of the Treasury, where he was responsible for oversight and management of the Department's largest investments in the financial sector and was the principal architect of AIG's restructuring and recapitalization. Prior to joining the Treasury, he served as managing director and global co-head of Corporate Restructuring at Lazard from 2000-08. Before joining Lazard, he was partner and head of the Corporate Restructuring practice at Cleary, Gottlieb, Steen & Hamilton. Mr. Millstein is a lecturer in law at Columbia Law School, where he teaches a course on private capital, and an adjunct professor of law at Georgetown University, where

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