Select Issues from the ABI Chapter 11 Commission Report

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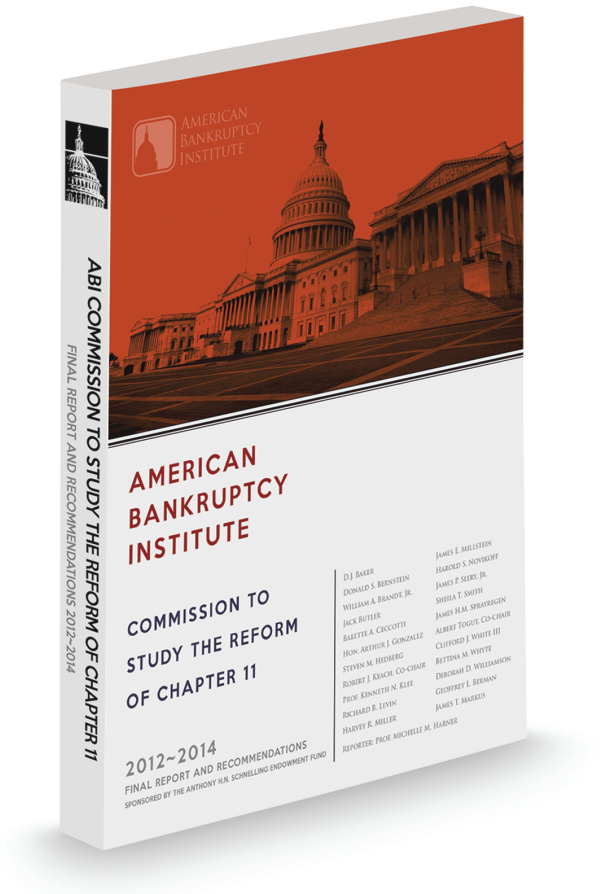

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COMMISSION TO STUDY THE REFORM OF CHAPTER 11

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ABI Commission to Study the Reform of Chapter 11

Overview of Selected Recommendations and Findings
ABI/UMKC Midwestern Bankruptcy Conference
Kansas City, MO

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Why Reform? Why Now?

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

2

Approach to Reform

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

3

Approach to Reform

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

4

Approach to Reform

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

5

Key Themes of Recommendations

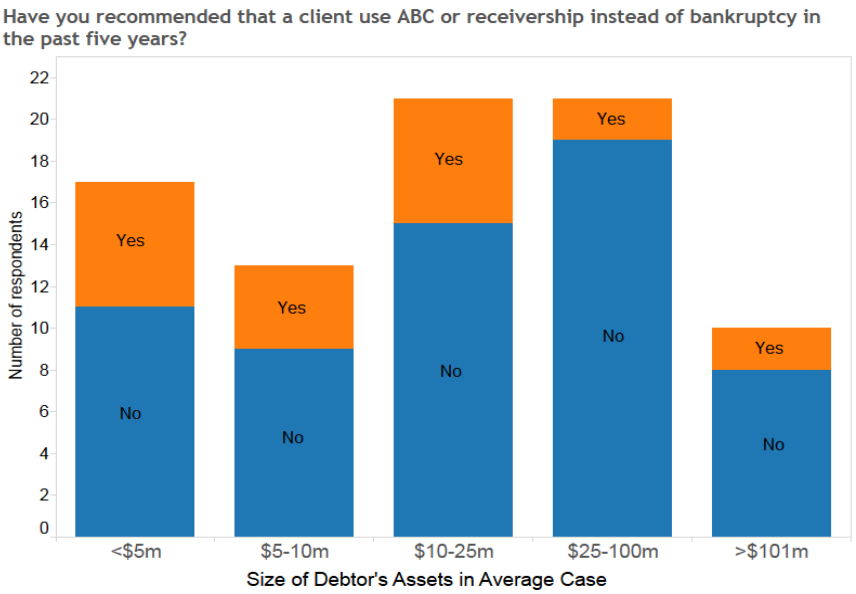
- Reduce barriers to entry
- Facilitate certainty and more timely resolution of disputed matters
- Enhance exit strategies for debtors
- Create an effective alternative restructuring scheme for small and medium-sized firms

6

Small and Middle Market Issues

- Does one-size-fit-all in chapter 11?
- Is chapter 11 working for smaller and middle market companies?

7



8

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%**	

9

Key Principles: SME

- For purposes of these principles, the term "***small or medium-sized enterprise***" ("***SME***") means a business debtor with—

  (i) No publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's case; and

  (ii) Less than $10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date

- SAREs excluded from SME principles

10

Key Principles: SME

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

(Report, at 291, 294, 297)

11

Key Principles: Executory Contracts and Unexpired Leases

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

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

12

Key Principles: Costs in Chapter 11

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

(Report, at 55, 59-61)

13

Key Principles: General Plan Provisions

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

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

14

Preference Claims

- Commission heard substantial testimony on preference claims from trade creditors, as well as those who serve as bankruptcy trustees and lenders

- Commission considered all possibilities, including eliminating preferences completely; shifting burden of proof on creditor defenses; fee shifting; and maintaining the status quo

15

Preference Claims

"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."

- *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)

16

Key Preference Principles

- "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)."
- is the quote from our recommendations? If so we should say so

17

Key Preference Principles

- "The trustee must plead with particularity factual allegations in the complaint that establish a plausible claim for relief under section 547."
- Increase small claims defense to $25,000 and venue provision to $50,000 (and clarify that the latter applies to preference litigation)

18

Key Related Principle

- "A court should not approve any proposed postpetition financing under section 364 that grants a lien on, or any interest in the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code (including through a superpriority claim)." (moved)

19

Section 503(b)(9) Claims

- Commission heard competing testimony regarding the impact of section 503(b)(9) claims—some witnesses emphasized the importance of this treatment to trade creditors while others suggested such claims imposed barriers to confirmation and successful reorganizations
- Commission carefully balanced competing interests, considering overall chapter 11 scheme and its objectives for debtors *and creditors*

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Section 503(b)(9) Claims

- Proposed principles relating to section 503(b)(9) claims and reclamation rights include:
  - Maintain section 503(b)(9) in current form, with the following clarifications:
    - Include drop shipment transactions
    - Should be in lieu of any other remedies, including reclamation and critical vendor treatment
  - Remove concept of reclamation from Bankruptcy Code

21

Key Principles: Avoiding Powers and *In Pari Delicto*

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

(Report, at 148, 186)

22

Key Principles: Estate Neutral

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

(Report, at 32)

23

Key Principles: IP

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

(Report, at 122, 126)

24

Key Principles: Section 363x Sale

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

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

25

Conclusion

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

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AVOIDING UNINTENDED CONSEQUENCES: ABI COMMISSION PROPOSALS TO TIGHTEN A TRUSTEE'S AVOIDING POWERS IN CHAPTER 11

Prof. Michelle Harner*

The ABI Commission to Study the Reform of Chapter 11 (the "Commission") reviewed extensive research, data, and testimony in developing its proposed recommendations. Those recommendations, set forth in the Commission's *Final Report and Recommendations*, dated December 2014 (the "Report"),[1] cover all aspects of chapter 11 practice, including a trustee's[2] avoiding powers under chapter 5 of the Bankruptcy Code. Indeed, some of the most passionate testimony submitted to the Commission concerned sections 547, 548, and 550 of the Bankruptcy Code.[3]

The witness testimony before the Commission discussed various aspects of a trustee's avoiding powers and offered varying perspectives on the issues and challenges facing litigants and courts in these matters. For example, several witnesses expressed frustration with the perceived "strike suit" nature of preference litigation: trustees send demand letters or file complaints with little diligence concerning the merits of the claim or any statutory defenses in the hopes of extracting a settlement. On the other hand, trustees may not have access to accurate business records or know the identity of appropriate claimants until the litigation is commenced. All sides of the debate, however, recognized the need for a fair and equitable process, which they perceived lacking under current practice.

In addition, the Commission identified several aspects of uncertainty in avoiding powers litigation, arising primarily from splits in the case law on key legal issues. These issues included: a defendant's ability to use prepetition claims paid under section 503(b)(9) as part of its new value defense under section 547(c)(4);[4] a trustee's ability to pursue avoidance actions if all unsecured creditors have been paid[5] or, alternatively, they will not receive any recovery from

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* Professor of Law, University of Maryland Francis King Carey School of Law. Prof. Harner was honored to serve as the Reporter to the ABI Commission to Study the Reform of Chapter 11. The views expressed in this outline are those of the author and are intended to spark a meaningful dialogue about chapter 11 reform. The comments are not attributable to the American Bankruptcy Institute or the ABI Commission to Study the Reform of Chapter 11.

[1] FINAL REPORT AND RECOMMENDATIONS OF THE ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11, Dec. 2014, *available at* www.commission.abi.org.

[2] For purposes of this outline, the use of the term "trustee" also includes a debtor in possession, as applicable under section 1107 of the Bankruptcy Code.

[3] *See generally* Report, *supra* note 1, § V.C, at 148-156.

[4] *Compare In re* Commissary Operations, Inc., 421 B.R. 873 (Bankr. M.D. Tenn. 2010) (allowing creditor to include invoices paid under section 503(b)(9) as new value), *with* Siegel v. Sony Electronics, Inc. (*In re* Circuit City Stores, Inc.), 2014 WL 4428344 (Bankr. E.D. Va. Sept. 8, 2014) (not allowing invoices paid under section 503(b)(9) to be used for new value defense). *See also* Friedman's Liquidating Trust v. Roth Staffing Cos. (*In re* Friedman's, Inc.), 738 F.3d 547 (3d Cir. 2013) (addressing issue in context of invoices paid under critical vendor order and allowing creditor to include invoices as new value).

[5] *Compare* Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 80, 97-98 (S.D.N.Y. 2008) (trustee lacked standing when unsecured creditors would not benefit from the recovery), *with* MC Asset Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 534 (5th Cir. 2012) (trustee had standing, regardless of the fact that unsecured creditors have been satisfied in full).

avoidance actions because of unpaid senior claims;[6] the meaning of "benefit of the estate" in the context of section 550;[7] and the burden of proof for establishing a fraudulent transfer action under section 548 of the Bankruptcy Code.[8]

This outline summarizes the Commission's deliberations and proposed recommendations on a trustee's avoiding powers under the Bankruptcy Code. The matters are addressed in more detail in Section V.C of the Report.[9]

I. Preference Claims

A distressed company and its creditors face a number of challenges as the company's financial situation deteriorates and the creditors' prospects for repayment diminish. The company finds it increasingly difficult to access capital; yet, that may be exactly what is needed to turn around the operations of the business and improve liquidity. Creditors are often critical to the company's operational turnaround, but they need payment from the company for the goods or services being provided. Unfortunately, distressed companies may address their own capital needs by extending the terms of payment to trade creditors (or selectively paying only some of their trade creditors), which may create liquidity issues for the trade creditors themselves.

This dilemma may cause the company and creditors to make imprudent choices prior to a bankruptcy filing.[10] One such choice may involve selective payments to creditors, which help some but significantly disadvantage other creditors. A distressed company may choose to pay one creditor over, or to the exclusion of, another because the preferred creditors' goods or services are more vital to the company's operations or because the preferred creditor is making the most "noise" and threatening legal action at a very tumultuous time. Regardless of the reason, selective creditor payments during the prepetition period may actually accelerate a company's financial decline, as the company spends money sporadically and creditors "race to the courthouse" to encourage those payments.

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[6] *See generally* Report, *supra* note 1, § V.C.1, at 150-151.

[7] *Compare* Trans World Airlines, Inc., v. Travellers Int'l AG. (*In re* Trans World Airlines, Inc.), 163 B.R. 964, 972–73 (Bankr. D. Del. 1994) (benefit to the estate "clearly contemplates the use of avoidance action recoveries in the operation of the business in a manner which only indirectly benefits creditors"), *with* Wellman v. Wellman, 933 F.2d 215, 218–19 (4th. Cir. 1991) (avoidance action that primarily benefitted debtor individually was not for the benefit of the estate).

[8] *Compare* Silagy v. Gagon (*In re* Gabor), 280 B.R. 149, 155 (Bankr. N.D. Ohio 2002) (burden of proof for a fraudulent transfer claim is a preponderance of the evidence); Thompson v. Jonovich (*In re* Food & Fibre Prot., Ltd.), 168 B.R. 408, 418 (Bankr. D. Ariz. 1994) (stating "[a]ctual intent may be proven by the Trustee by a preponderance of the evidence"), *with* Glinka v. Bank of Vt. (*In re* Kelton Motors, Inc.), 130 B.R. 170, 179 (Bankr. D. Vt. 1991) (burden of proof for actual fraud claims under section 548 is clear and convincing evidence); Morse Operations, Inc. v. Goodway Graphics of Va., Inc. (*In re* Lease-A-Fleet, Inc.), 155 B.R. 666, 673–74 (Bankr. E.D. Pa. 1993) (same); Taylor v. Rupp (*In re* Taylor), 133 F.3d 1336, 1338 (10th Cir.1998) (acknowledging a split in the courts regarding the burden of proof, but declining to decide the issue because trustee satisfied higher standard of clear and convincing evidence).

[9] The Commission also addressed a trustee's avoiding powers in the context of qualified financial contracts, derivatives, and the safe harbors under the Bankruptcy Code. *See* Report, *supra* note 1, § IV.E, at 94-111. This outline does not address those provisions.

[10] For a detailed review of the origins and purpose of preference law, see Report, *supra* note 1, § V.C.1, at 149.

Preference law was originally enacted to mitigate the consequences of the race to the courthouse. The basic concept was to create a tool for the trustee in bankruptcy to unwind prepetition payments that had the hallmarks of payments resulting from litigation threats and other pressure tactics. The preference tool is frequently described as leveling the playing field among similarly situated creditors in that it allows the trustee to pull back payments that preferred certain unsecured creditors and to reallocate those amounts among all general unsecured creditors.[11]

The Commission's research and witness testimony strongly suggest that preference law no longer serves its original purpose.[12] As distressed companies file bankruptcy with more, if not all of their capital structure secured by the company's assets, the company's valuation in the bankruptcy case may not support full payment of secured creditors and administrative claimants.[13] Moreover, the debtor may request authority to use the estate's rights in, and recoveries from, any chapter 5 avoidance actions as adequate protection for prepetition debt under section 361 of the Bankruptcy Code or as collateral for postpetition financing under section 364 of the Bankruptcy Code.[14] As a result, preference recoveries in those cases often do not benefit the general unsecured creditors. Rather, the recoveries are distributed to the holders of more senior debt. One witness summarized the evolution of preference law as follows:

> The original intent of preference recovery has been lost. The concept of leveling the playing field so those few creditors who received preferential treatment and were paid money when other like creditors did not should surrender those funds back to the creditor pool of like creditors so it can be equally distributed just isn't the reality. Instead, generally speaking, the only parties who benefit from preference recoveries are the professionals handling those matters. In all of the cases I have been involved in, or those where I have closely watched through the filings, I have never seen any of the trade credit preference recoveries going into the unsecured creditors' pool for distribution. Of the near $3 million I returned in one case, I didn't see three dollars.[15]

In addition, witnesses offered numerous examples of being named as a defendant in a preference lawsuit in which they had valid, readily identifiable defenses.[16] One witness even cited an

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[11] *See, e.g.,* John C. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 VA. L. REV. 249, 261 (1981).

[12] For an overview of this research and testimony, see Report, *supra* note 1, § V.C.1, at 149.

[13] *See, e.g., 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) (proceeds of avoidance actions used solely to satisfy administrative claims).

[14] *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.

[15] *Written Testimony of Valerie Venable: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2-3 (May 21, 2013), available at www.commission.abi.org.

[16] *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 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

instance in which the debtor in possession had assumed his company's contract, but the postconfirmation trustee subsequently sued his company under preference law for prepetition payments received under that contract. As he explained:

> The Litigation Trustee insisted that the payments made before the executory contract was assumed were recoverable as preferences. It was economically unfeasible to spend a lot of money on legal fees to prove or disprove the Litigation Trustee's hypothesis. And, I would have spent more money running an ordinary course of business analysis. The matter for nuisance value was settled and less than $2,000 was paid to the Litigation Trustee to do so.[17]

The Commission considered all of the research, data, and testimony in developing the following recommendations on preferences in chapter 11 cases:[18]

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

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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."), *available at* www.commission.abi.org.

[17] *Written Testimony of Thomas Demovic: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (May 21, 2013), available at www.commission.abi.org.

[18] Report, *supra* note 1, § V.C.1, at 148.

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).

The Commission's general approach to preference reform was to focus on potential abuses of the preference system and to foreclose opportunities for such abuse.[19] The most notable recommendations in this respect include the increase in the nominal preference defense of section 547(c)(9) from $6,225 under current law to $25,000, and to increase the small venue provisions of 28 U.S.C. § 1409(b) to $50,000.[20] In addition, the Commission recommended enhanced due diligence requirements for trustees investigating and initiating preference litigation. It believed that this approach—as opposed to shifting the burden of proof on the statutory defenses—struck an appropriate balance that protected litigants from strike suits and trustees from a burden that they may not be able to meet in cases where, for example, the debtors' business records are in shambles or nonexistent.[21]

The Commission also analyzed data and research concerning liens on avoidance actions in the context of adequate protection and postpetition financing.[22] It determined that, in the context of a new financing package, a lender's pre-existing rights and expectations were not being affected and no justification existed for potentially removing the avoidance action asset from the reach of the estate and other creditors.[23] With respect to adequate protection, however, the Commission observed a slightly different landscape, noting the potential impairment of prepetition lenders' existing rights and expectations. Accordingly, in the latter scenario only, the Commission believed that prepetition lenders should be able to receive the proceeds of any avoidance actions to the extent warranted under section 507(b) because of a failure in their adequate protection.[24] Specifically, the Commission recommended:[25]

[19] *See* Report, *supra* note 1, § V.C.1, at 150-151.
[20] Court are divided on whether 28 U.S.C. § 1409(b) as currently drafted applies to preference litigation. *See, e.g., In re* Excel Storage Prods., L.P., 458 B.R. 175 (Bankr. M.D. Pa. 2011) (reviewing case law split). The Commission's recommendation would resolve this split.
[21] *Id.*
[22] *See id.*, § IV.B, at 67-79; *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* www.commission.abi.org.
[23] *See* Report, *supra* note 1, § IV.B.2, at 73.
[24] *See id.*, § IV.B.1, at 67.
[25] *Id.*, § IV.B, at 67, 73.

Recommended Principles (Postpetition Financing):

- 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.

Recommended Principles (Adequate Protection):

- 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).

II. Recoveries Under Section 550

If a trustee is successful in avoiding a transfer as either a preference under section 547 or as a fraudulent transfer under section 548, she must then seek to recover the value of such transfer under section 550 of the Bankruptcy Code.[26] The Commission addressed two issues in the context of section 550: (i) whether the trustee can pursue recoveries from foreign subsequent transferees; and (ii) the meaning of "for the benefit of the estate."[27]

The questionable ability of a trustee to pursue recovery from subsequent foreign transferees was highlighted in the chapter 11 case of Bernie Madoff.[28] In *Madoff*, the trustee sought to recover transfers not only from foreign feeder funds that invested money with Madoff, but also the foreign customers of the foreign feeder funds who received distributions indirectly from the estate through the foreign feeder funds.[29] Both the foreign feeder funds and the foreign customers were subsequent transferees under section 550 of the Bankruptcy Code, but a question existed concerning the extra-territorial application of section 550(a). The court in *Madoff* found no evidence that Congress intended section 550(a) to have extra-territorial application.[30] Consequently, the trustee was unable to recover significant sums that would have benefitted the *Madoff* estate.

The Commission reviewed the *Madoff* scenario and similar case law to analyze whether section 550 should have extra-territorial application in certain circumstances. The Commission was concerned primarily with two competing interests: disparity in treatment among parties

[26] 11 U.S.C. § 550.
[27] *See* Report, *supra* note 1, § V.C.2, at 151.
[28] *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC (*In re* Madoff Sec.), 513 B.R. 222 (S.D.N.Y. 2014).
[29] *Id.* at 225-226.
[30] *Id*. at 231.

receiving prepetition avoidable transfers and appropriate deference to the applicable law and parties' expectations in foreign jurisdictions.[31] To balance these competing interests, the Commission drew upon aspects of chapter 15 practice and recommended that trustees be permitted to pursue avoidance actions extra-territorially, provided that such actions comply with general principles of comity and are reasonably necessary to protect the estates' interests.

The benefit for the estate issue involved a split in the circuits, with some courts interpreting the phrase broadly such that any potential benefit (direct or indirect) to the estate is sufficient,[32] and other courts using a more narrow interpretation that required some direct benefit to creditors.[33] The Commission analyzed the case law and, for the most part, did not want section 550 to foreclose meritorious avoidance actions under other sections of the Bankruptcy Code. Accordingly, the Commission adopted the broader interpretation of section 550 to, among other things, allow the trustee to pursue viable claims and causes of action and then permit allocation issues to be resolved in due course in the chapter 11 case.[34] In light of the expansive concept of "estate" under section 541 of the Bankruptcy Code, this approach generally aligns with one of the Commission's overarching objectives of facilitating more successful restructurings that enhance value for all stakeholders in the chapter 11 case.

III. Other Principles Related to Avoiding Powers

The Commission also addressed several issues that indirectly impact avoidance actions under chapter 5 of the Bankruptcy Code in chapter 11 cases. For example, in the context of the burden of proof in fraudulent transfer actions, the Commission recommended—as a global principle—that "[t]he burden of proof in all matters under title 11 of the U.S. Code … be the preponderance of the evidence standard unless otherwise expressly stated in the applicable section of the Bankruptcy Code."[35] In addition, the Commission reviewed extensively issues surrounding section 503(b)(9) of the Bankruptcy Code, which frequently are claims held by creditors that also are subject to preference litigation. Although the Commission received testimony highly critical of section 503(b)(9),[36] it found the evidence and testimony supporting the value of that section to

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[31] *See* Report, *supra* note 1, § V.C.2, at 154-156.

[32] *See, e.g., 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) (for the benefit of the estate should be construed broadly). *See also* Weaver v. Aquila Energy Marketing Corp., 196 B.R. 945, 956 (S.D. Tex. 1996) (section 550 requires only some identifiable benefit to the estate).

[33] *See, e.g., In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999) ("any recovery of preferences in this case will benefit only the Successor Corporation" and "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) ("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).

[34] *See* Report, *supra* note 1, § V.C.2, at 154-156.

[35] *See id*., § VIII.A, at 304. As noted above, this issue currently represents a split in the case law.

[36] *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), *available at* www.commission.abi.org; *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), *available at* www.commission.abi.org; *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

trade creditors more persuasive.[37] It did recommend, however, that trade creditors receiving payments under section 503(b)(9) not be entitled to additional payments under either a reclamation or critical vendor theory.[38] The Commission also would include "drop shipment" transactions within the scope of section 503(b)(9), provided that the debtor directed the shipment to the third party in the ordinary course of business.[39]

Finally, the Commission considered whether a trustee should be subject to the *in pari delicto* defense in litigation commenced against third parties.[40] The *in pari delicto* doctrine generally forecloses litigation against defendants where the plaintiff acted in concert with the defendants or was otherwise involved in the alleged wrongdoing underlying the complaint.[41] Accordingly, the defendants may assert the defense against a company in cases involving alleged wrongdoing by the company and, for example, its officers and directors. The question then becomes whether the trustee in that company's bankruptcy case also is subject to the defense, to the same extent the company would have been outside of bankruptcy. The argument by trustees is that the trustee is not the perpetrator of the "bad acts" and recoveries from the trustee's litigation belongs to the creditors in the bankruptcy and not the perpetrators, therefore the *in pari delicto* doctrine should not apply.[42] A recent case on the application of the *in pari delicto* doctrine held that the trustee's claims were in fact barred by the doctrine.[43]

The Commission robustly debated this issue. Ultimately, the Commissioners suggested that a trustee in bankruptcy not be subject to the *in pari delicto* defense.[44] The Commissioners could not, however, reach a consensus regarding the application of the defense against other parties representing the estate, such as creditors' committees and postconfirmation trustees. Also, it is worth noting that courts generally do not permit defendants to assert the *in pari delicto* defense in litigation commenced under sections 547 and 548 of the Bankruptcy Code.[45]

IV. General Takeaways

The Commission's recommendations on chapter 5 avoidance actions strive to provide greater clarity and a more level playing field for both trustees and creditors. The preference recommendations would help to reduce, for example, mass filings of preference complaints on

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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* www.commission.abi.org.

[37] *See generally Transcript, NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013), *available at* www.commission.abi.org.

[38] *See* Report, *supra* note 1, § V.E.1, at 169.

[39] This aspect of section 503(b)(9) claims is an area of ambiguity under the case law. *See In re* Momenta, Inc., 455 B.R. 353 (Bankr. D.N.H. 2011); *In re* Circuit City Stores, Inc., 432 B.R. 225 (Bankr. E.D. Va. 2010); *In re* Plastech Engineered Prods., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008).

[40] *See* Report, *supra* note 1, § V.H, at 186-191.

[41] *See id.*

[42] There are other exceptions to the application of the *in pari delicto* doctrine that are not pertinent for this outline.

[43] *See* Peterson v. McGladrey, LLP, No 14-1986 (7th Cir. July 7, 2015).

[44] *See id.*

[45] *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); McNamara v. PFS (*In re* Pers. & Bus. Ins. Agency), 334 F.3d 239, 245–47 (3d Cir. 2003).

the last day of the statute of limitations against hundreds of parties who may have valid defenses to the alleged preferential transfers. Although parties may still need to vet certain of the information and validate certain claims and defenses, preference litigation would likely become more focused and, hopefully, less litigious. Moreover, the recommendations would eliminate complaints or demand letters seeking amounts below $25,000 or seeking to prosecute claims of less than $50,000 in remote jurisdictions. Congress or the courts would need to develop objective criteria to evaluate trustees' due diligence efforts, but even a relatively low or flexible standard may provide significant advantages over certain current practices—at least in some cases.

The recommendations on section 550 and the general burden of proof, including under section 548, again seek to provide more certainty and uniformity in chapter 11 cases. Providing clearer rules to help parties understand their rights and anticipate outcomes would streamline litigation matters and help parties reach consensual resolutions. Even in those cases where a consensual resolution is not possible, eliminating disputes over issues such as jurisdiction, pleading standards, and the burden of proof can help focus the parties and the court on the core substantive issues. As the saying goes, "time is money"; this saying is particularly apt in chapter 11 cases and certainly to creditors who are the recipients of preference demands or lawsuits. The Commission's recommendations are designed to help parties save time and money, to the benefit of the estate and all of the debtor's creditors.