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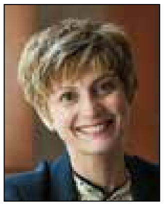
Legislative Update

By Prof. Michelle M. Harner[1]

Are Small- and Medium-Sized Companies Worth Saving?



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What may look like one person and some inconsequential assets to an outsider may be something very different to that person, her family and the individuals she employs. It might be a business that makes significant contributions to its customers and community, and the value of this business may not reside primarily in its assets — at least, not in the early stages of the business's life cycle. Rather, the value of this business might be in its provided services, the products that it manufactures or is working to develop, the paychecks written to employees, and the payments made to vendors and suppliers.

In fact, small- and medium-sized enterprises (SMEs) make up "99.7 percent of U.S. employer firms, 63 percent of net new private-sector jobs, [and] 48.5 percent of private-sector employment."[2] For purposes of these statistics, the U.S. Small Business Administration defines a "small business" as a company with fewer than 500 employees.[3] More than half "of the working population (120 million individuals) works in a small business."[4] These small businesses also represent "98 percent of firms exporting goods, and 33 percent of exporting value."[5]

Despite their importance to the U.S. economy, SMEs tend to fail at very high rates.[6] Part of this phenomenon likely relates to inexperience and unsustainable business models. Part of it, however, also likely relates to the perception that many SMEs are not worth saving (*i.e.*, they do not possess going-concern value as business entities). Admittedly, liquidation or closure may be the best option for some SMEs, as not every business venture is viable. But for those that are viable — for the honest-but-unfortunate debtors — shouldn't the law offer a workable reorganization alternative?

Consider the options for distressed SMEs under the current law. An SME can invoke an often very expensive, somewhat effective (although many would say ineffective) chapter 11 reorganization process.[7] An SME can reach a consensual out-of-court resolution with its creditors, but a lack of negotiating leverage in deals with secured creditors and hold-outs in attempted compositions or arrangements with unsecured creditors can make this alternative difficult and suboptimal from the debtor's perspective. An SME or its creditors could consider a state law receivership or an assignment for the benefit of creditors (ABCs). These processes serve some distressed companies and their creditors well, facilitating liquidations or foreclosure sales, usually in a manner that is faster and less expensive than bankruptcy. They also *may* help a distressed SME save its business (*e.g.*, an SME owner may buy back the assets or start over), but this result may come at a potentially significant cost in relationships, as unsecured

1 This article summarizes certain recommendations of the ABI Commission to Study the Reform of Chapter 11. The author explains certain issues and considerations underlying these recommendations as they relate to small- and medium-sized enterprises, which are more fully examined in the Commission's Final Report and Recommendations. This article presents the author's perspectives on the process, and such observations are not directly attributable to ABI or the ABI Commission to Study the Reform of Chapter 11.

2 *See* SBA Office of Advocacy, Frequently Asked Questions 1 (March 2014), *available at* sba.gov/sites/default/files/FAQ_March_2014_0.pdf (unless otherwise indicated, all links in this article were last visited on June 16, 2015).

3 *Id.* The ABI Commission selected a different metric to define SMEs in its Final Report and Recommendations. Nevertheless, there is substantial overlap in the companies captured by the two definitions.

4 Jason Nazar, "16 Surprising Statistics About Small Businesses," *Forbes*, Sept. 9, 2013, *available at* forbes.com/sites/jasonnazar/2013/09/09/16-surprising-statistics-about-small-businesses/.

5 *See* Frequently Asked Questions, *supra* n.2.

6 *Id.* ("About half of all new establishments survive five years or more and about one-third survive 10 years or more.").

7 As explained below, the testimony before the ABI Commission strongly suggests that chapter 11 is no longer effective for SMEs. The Report also discusses commentary regarding the use and role of federal bankruptcy law in distressed SME situations. *See* Commission Report, Section VII. *See also, e.g.*, Edward R. Morrison, "Bargaining Around Bankruptcy: Small Business Workouts and State Law," 38 *Journal of Legal Studies* 255 (2009). Not surprisingly, commentators offer different approaches to resolving financially distressed SMEs. The differences among these approaches often turn on factors such as the proponents' views regarding the objectives or policies served by a federal bankruptcy scheme or their general perspectives on smaller-business enterprises. The Commissioners believed that all approaches warranted consideration and contributed value to their deliberations.

creditors (including vendors and customers) rarely receive any meaningful recovery in these proceedings. Moreover, from the creditors' perspective, receiverships and ABCs vary, sometimes greatly, from state to state. Even SMEs have multi-state operations, and state law remedies may prove inefficient in such situations.

So what would an effective reorganization scheme for SMEs look like? Based on the testimony presented to the ABI Commission to Study the Reform of Chapter 11 and other anecdotal evidence, such a scheme would need to:

- *Be cheap and simple.* Note that the word "quick" is not on this list. Although for some SMEs speed might be best, others may require time to figure out or implement their restructuring plans.
- *Include the appropriate oversight and monitoring mechanisms.* These elements are often critical in the context of SMEs that frequently have little sophisticated business, financial or restructuring experience.
- *Offer an exit strategy that allows the owners to maintain their ownership and control of the business.* Individuals who have devoted countless hours and perhaps all of their savings to a business will rarely enter a process voluntarily in which they will lose that investment in its entirety.

These objectives are simple to state but, like many issues in distressed situations, difficult to achieve. Moreover, SMEs vary in size, industry and complexity, which further complicates the task. An SME may employ only a few individuals, have only one significant secured creditor, and have relatively nominal unsecured debt. Alternatively, an SME may employ 50 or more individuals, have multi-state operations or facilities, have multiple secured creditors and have significant unsecured trade debt. Notably, the number of employees or the capital structure of the SME does not always indicate the simplicity or complexity of the issues at hand. In addition, an SME case may include personal-liability issues for the owners or founders that need resolution simultaneously with the SME's reorganization.

The ABI Commission considered the plight of distressed SMEs during its three-year study and deliberative process, which resulted in its Final Report and Recommendations[8] and a set of recommended principles to govern SME chapter 11 cases. The full set of SME principles is set forth in Section VII of the Report.[9] This article

8 The Commission Report includes recommended principles on all aspects of chapter 11 cases; the SME principles are just one component. The full Report is available at commission.abi.org.
9 Commission Report, Section VII.

Alternatives Considered During Commission Process

Issue	Alternative 1 (ch. 12/13 model; no vote)	Alternative 2 (ch. 12/13 model; with vote)	Alternative 3 (ch. 11 with modifications)
Debtor in Possession	Yes, and should have all rights, powers and duties of traditional DIP under § 1107(a) (akin to § 1203). • DIP powers should include ability to obtain financing, assume and reject contracts, and exercise avoiding powers.	Yes, and should have all rights, powers and duties of traditional DIP under § 1107(a) (akin to § 1203). • DIP powers should include ability to obtain financing, assume and reject contracts, and exercise avoiding powers.	Yes, subject to appointment of trustee, and should have all rights, powers and duties of traditional DIP under § 1107(a).
Oversight	Standing trustee model. • Could call a "judicial administrator" or "monitor" to distinguish from traditional trustees. • SME trustee would handle portfolio of cases so that one or two individuals could handle most jurisdictions. • SME trustees would not only be familiar with bankruptcy but also with appropriate business and financial experience for the types of business cases typically filed in the jurisdiction. • U.S. Trustee or bankruptcy administrator (BA) should select and oversee SME trustees. • SME trustees should be responsible for vetting petitions and disclosures by debtors, holding initial debtor interviews, requesting any information or filings not made by the debtor, and moving to dismiss the SME case if the debtor does not timely satisfy the Code's filing requirements, as requested by the SME trustee. • SME trustees should advise the debtor on the content of its plan and performance under the plan (other than on legal matters). • SME trustees could be charged with collecting and distributing plan payments, but allowing reorganized debtor to handle post-confirmation matters subject to periodic reports would reduce the SME trustees' workload and allow SME debtors to obtain same discharge and control over reorganized business and assets as provided other chapter 11 debtor. • SME trustees should be paid in a manner similar to chapter 12 or 13 trustees.	Standing trustee model. • Could call a "judicial administrator" or "monitor" to distinguish from traditional trustees. • SME trustee would handle portfolio of cases so that one or two individuals could handle most jurisdictions. • SME trustees would not only be familiar with bankruptcy but also with appropriate business and financial experience for the types of business cases typically filed in the jurisdiction. • U.S. Trustee or BA should select and oversee the SME trustees. • SME trustees should be responsible for vetting petitions and disclosures by debtors, holding initial debtor interviews, requesting any information or filings not made by the debtor, and moving to dismiss the SME case if the debtor does not timely satisfy Code's filing requirements, as requested by SME trustee. • SME trustees should advise the debtor on the content of its plan and performance under the plan (other than on legal matters). • SME trustees could be charged with collecting and distributing plan payments, but allowing the reorganized debtor to handle post-confirmation matters subject to periodic reports would reduce the SME trustees' workload and allow SME debtors to obtain the same discharge and control over reorganized business and assets as provided other chapter 11 debtor. • SME trustees should be paid in a manner similar to chapter 12 or 13 trustees.	No mandatory committee or estate neutral; may be appointed upon request. • Could call a "judicial administrator" or "monitor" to distinguish from estate neutral/examiner role in chapter 11. • Committee, if appointed, should serve traditional role under § 1103. • Estate neutral should serve role identified by court in order appointing neutral. Those duties could include advising the debtor on operational and financial matters, as well as the content and negotiation of its plan. • Estate neutral should represent the interests of the estate and be paid by the estate. The Code could establish a fee structure available for the estate neutral in SME cases to control costs and increase certainty. Such structure could be based on the size of the case or amount of creditor distributions.

summarizes these principles, and explains the alternatives and key issues evaluated by the Commission in developing the SME principles.

In a nutshell, the SME principles would apply automatically to non-public entity debtors with assets or liabilities up to $10 million.[10] A non-public entity debtor with assets or liabilities between $10 million and $50 million could ask to be treated as an SME debtor.[11] The SME provisions would include a presumption against the appointment of a creditors' committee, but the principles would allow the appointment of an estate neutral to assist the debtor with various aspects of its case, including the operation of the business and the development of a reorganization plan. The role of any estate neutral would be limited in scope and cost, as directed by the court's appointment order.[12] Within 60 days of the petition date, the SME debtor must submit a proposed timeline for its chapter 11 case.[13] The court will review the proposal, as well as the viability of the case, in entering an order pursuant to § 105(d)(2)(B) of the Bankruptcy Code to set deadlines for the filing of the debtor's disclosure statement and plan. The plan itself may allow the pre-petition equityholders to retain their ownership interests if certain conditions regarding its post-confirmation operation and the treatment of pre-petition creditors' claims are satisfied.[14]

Notably, this synthesized version of the SME principles does not do justice to the in-depth research, thoughtful witness testimony and multiple months of deliberations undertaken in connection with the Commission's SME recommendations. For example, the Commission's research and testimony at its many public field hearings indicated that distressed SMEs, in most instances, basically refuse to use the chapter 11 process. Some witnesses and Commissioners suggested that SMEs view the current chapter 11 as a death sentence, either for the SME's business or its pre-petition ownership structure. Others suggested that receiverships or ABCs are more cost-effective and quicker than the current chapter 11 alternative. The following witness statement summarizes many of these observations nicely: "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."[15]

In light of this evidence, the Commission considered several different alternatives (and different iterations of each alternative) for distressed SMEs during its deliberations. The chart is a modified version of one chart used by the Commission's committee that focused on SMEs[16] to vet the strengths and weaknesses of different approaches, drawing on prior proposals to reform chapter 11 for smaller companies,[17] the current chapters of the Bankruptcy Code and the options for business debtors under the 1898 Bankruptcy Act.[18]

Not surprisingly, the Commission focused much of its discussion on the three aforementioned critical features for an effective SME reorganization scheme (*e.g.*, simplicity, oversight and exit). The Commissioners felt strongly that SMEs' management teams — like their counterparts in larger companies — would resist a process that replaced them, or mandated a trustee or agency oversight mechanism during the reorganization.[19] In addition, they expressed concerns regarding the additional number and expertise required of standing trustees, to the extent that such trustees assumed a meaningful role in smaller business cases. The Commissioners were also mindful of the testimony suggesting that many SMEs

10 *See* Commission Report, Section VII.A (the definition of SMEs also excludes single-asset real estate cases). Based on research reviewed in connection with the Report, the Commission's proposed definition of an SME debtor would capture approximately 85-95 percent of the companies that file for chapter 11 protection. The Commission considered using revenue, sales, number of employees or other metrics in lieu of (or in addition to) the straight-asset or liability test. The Commission determined that all potential metrics (including assets or liabilities) were subject to manipulation and dispute, and that other metrics may or may not have greater meaning than assets and liabilities depending on factors such the debtor's industry and its stage of development.

11 *See* Commission Report, Section VII.A.

12 *See* Commission Report, Section VII.C. For the Commission's full proposed principles on the estate-neutral concept and the related narrative, *see* Commission Report, Section IV.A.3.

13 *See* Commission Report, Section VII.D.

14 *See* Commission Report, Section VII.E.

15 Written Statement of Daniel Dooley, ASM Field Hearing Before the ABI Comm'n. to Study the Reform of Chapter 11, at 2-3 (April 19, 2013), *available at* commission.abi.org.

16 This chart is reproduced in a modified form with the permission of the ABI Commission co-chairs, **Robert J. Keach** (Bernstein Shur, Portland, Maine) and **Albert J. Togut** (Togut, Segal & Segal LLP; New York).

17 *See, e.g.*, National Bankruptcy Review Commission Final Report, *Bankruptcy: The Next Twenty Years*, Oct. 20, 1997, *available at* govinfo.library.unt.edu/nbrc/reporttitlepg.html; Thomas E. Carlson and Jennifer Frasier Hayes, "The Small Business Provisions of the 2005 Bankruptcy Amendments," 79 *Am. Bankr. L.J.* 645 (2005). In addition, the National Bankruptcy Conference has released proposed reforms for smaller debtors premised on amendments to chapter 12. *See* "A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize" (January 2010), *available at* nationalbankruptcyconference.org/images/NBC%20Small%20Business%20Rept%20Dec%2017,%202009.pdf.

18 Specifically, the Commission considered the chapter of the Act generally applicable to non-public companies, Chapter XI. Some key attributes of Chapter XI in this context include no mandatory trustee; the debtor remains in possession and primarily negotiated with a creditors' committee; the plan was similar to the composition or arrangement and could only address unsecured debt ("[A]n arrangement within the meaning of this Chapter shall include provisions modifying or altering the rights of unsecured creditors generally or some of class of them, upon any terms or upon any consideration."); and creditors could vote "yes" or "no" but could not propose a plan.

19 The Commission considered the reluctance of companies to file Chapter X cases under the Bankruptcy Act, which mandated a trustee and oversight by the U.S. Securities and Exchange Commission, and the preference for Chapter XI of the Act, which included no such mandates. *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).

Alternatives Considered During Commission Process (continued)

Deadlines	At the initial debtor interview, SME trustee should work with the debtor to establish a deadline for filing a plan. • Timeline should be filed with the court and should be freely amendable upon agreement of the DIP and SME trustee. • DIP should have the exclusive right to file a plan for 300 days, but failure to file a plan on or before the end of exclusive period should be cause for case dismissal or conversion.	At initial debtor interview, SME trustee should work with the debtor to establish a deadline for filing and soliciting acceptances of a plan. • Timeline should be filed with the court and be freely amendable upon agreement of the DIP and SME trustee, but any such agreement should not extend the DIP's exclusivity periods beyond that provided in § 1121.	Within a certain period of the petition date, DIP should develop and file with court a timeline for filing and soliciting acceptances of its plan. • DIP should be subject to exclusivity periods provided in § 1121. • If an estate neutral or committee is appointed, DIP should consult with estate neutral or committee in developing its timeline.

need targeted assistance to get them through, or to facilitate the flow of information or the negotiation of a plan during, a chapter 11 case. The Commission determined that an expanded version of its estate-neutral concept, with appropriate duties based on the needs of the case and limitations on cost, would work best.[20]

The Commission attempted to streamline the process in an SME case by creating an opportunity early on for the court and the parties to confer regarding the debtor's situation, as well as an appropriate course and timeline.[21] As previously mentioned, not every SME debtor will need significant time to develop a plan, and not every SME should reorganize. The court, with the assistance of the parties and the appointed estate neutral, could use this early status assessment to keep the SME moving forward on the correct path, whether it's a reorganization, sale or conversion/dismissal.

The Commission also spent considerable time debating the contours of an SME plan and the plan-confirmation process. Some Commissioners suggested that an SME should be able to propose and confirm a plan without soliciting a vote of creditors if the plan was fair and equitable and in the best interests of creditors.[22] Although some Commissioners were comfortable with this very general standard, others believed that more definition was needed, particularly given how easily debtors often satisfy the best-interests-of-creditors test.[23] To add definition, the Commission discussed using a test similar to the disposable-income test of chapter 12;[24] nevertheless, some Commissioners raised concerns (similar

20 The Commission considered a standing trustee concept — similar to the chapter 12 or 13 standing trustees — but opted for the estate neutral as being less troublesome for management, of potential utility to all parties and the court in the case, and something that could be tailored for the case. Although standing trustees are typically very talented individuals, they may not have the particular expertise that is needed. They also would likely have to perform tasks very different from those currently performed in chapter 13 and perhaps even chapter 12 cases. In addition, any expansion of the current standing trustee program would require additional funding, which may not exist. Although an estate neutral would impose a cost on the estate, the Commission determined that the cost could be controlled through a statutory fee structure or by the court's appointment order.

21 *See* Commission Report, Section VII.D.

22 The fair and equitable standard is currently set forth in § 1129(b) of the Bankruptcy Code. The best-interests-of-creditors test is set forth in § 1129(a)(7).

23 In general, the test requires the debtor or plan proponent to show that creditors are receiving, under the proposed plan, at least as much as they would receive in a hypothetical chapter 7 liquidation of the debtor. 11 U.S.C. § 1129(A)(7).

Alternatives Considered During Commission Process (continued)

Plan Content and Confirmation	Plan should satisfy the following provisions: • Payment of all administrative claims. • Distributions to secured creditors in an amount equal to the value of their allowed secured claims (*e.g.*, cash, installments, replacement lien, etc.), unless otherwise agreed. • Distributions to unsecured creditors in an amount equal to at least what they would receive in a chapter 7 liquidation. • Pre-petition equity interests may be reinstated provided that the plan distributes all of the debtor's projected disposable income to creditors under the plan for three years or such other period as determined by the court. • Disposable income should mean "income that is received by the debtor and that is not reasonably necessary to be expended for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business." • No creditor voting. • *Plan should be confirmed if in good faith, all fees paid, complies with Code, satisfies above-distribution requirements, and the court determines that the plan is in the best interests of creditors and is feasible.* • Timing on discharge may depend on whether SME trustee assumes responsibility for plan payments (*see* bullet in Oversight section).	Plan should satisfy the following provisions: • Payment of all administrative claims. • Distributions to secured creditors in an amount equal to the value of their allowed secured claims (*e.g.*, cash, installments, replacement lien, etc.), unless otherwise agreed. • Distributions to unsecured creditors in an amount equal to at least what they would receive in a chapter 7 liquidation. • Pre-petition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that all impaired classes have accepted the plan or the plan provides impaired classes of creditors that have rejected the plan with non-voting common stock, preferred stock, or similar ownership interests in the reorganized debtor on account of their allowed claims (an "SME equity retention plan"). • Filing of an SME equity retention plan by the debtor should terminate the debtor's exclusive periods to file and solicit acceptances of a reorganization plan. • Standard solicitation and creditor voting; • *Plan should be confirmed if in good faith, all fees paid, complies with Code, satisfies above-distribution requirements, and the court determines that the plan is in the best interests of creditors and is feasible.* • Timing on discharge may depend on whether SME trustee assumes responsibility for plan payments (*see* bullet in Oversight section).	Plan should satisfy the following provisions: • Payment of all administrative claims. • Distributions to secured creditors in an amount equal to the value of their allowed secured claims (*e.g.*, cash, installments, replacement lien, etc.), unless otherwise agreed. • Distributions to unsecured creditors in an amount equal to at least what they would receive in a chapter 7 liquidation. • Pre-petition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that all impaired classes have accepted the plan or the plan provides impaired classes of creditors that have rejected the plan with non-voting common stock, preferred stock, or similar ownership interests in the reorganized debtor on account of their allowed claims (an "SME equity retention plan"). • Filing of an SME equity retention plan by the debtor should terminate the debtor's exclusive periods to file and solicit acceptances of a reorganization plan. • Standard solicitation and creditor voting. • *Plan should be confirmed if in good faith, all fees paid, complies with Code, satisfies above distribution requirements, and the court determines that the plan is in the best interests of creditors and is feasible.* • Debtor should receive discharge on effective date and reorganized debtor should assume responsibility for implementing plan.
Miscellaneous	• SME debtor should be able to disclose information required by § 1125 in reorganization plan document, without filing a separate disclosure statement. • SME debtor should be able to combine hearing on the approval of its disclosure statement (or the § 1125 disclosures included in the plan) and the confirmation of the reorganization plan. • Forms should be developed for standard SME plans and disclosure statements, and *SME debtor should be required to use form.*	• SME debtor should be able to disclose information required by § 1125 in reorganization plan document, without filing a separate disclosure statement. • SME debtor should be able to combine hearing on the approval of its disclosure statement (or the § 1125 disclosures included in the plan) and the confirmation of the reorganization plan. • Forms should be developed for standard SME plans and disclosure statements, and *use of forms by SME debtor should be optional.*	• SME debtor should be able to disclose information required by § 1125 in reorganization plan document, without filing a separate disclosure statement. • SME debtor should be able to combine hearing on the approval of its disclosure statement (or the § 1125 disclosures included in the plan) and confirmation of reorganization plan. • Forms should be developed for standard SME plans and disclosure statements, and *use of forms by SME debtor should be optional.*

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to those voiced in the best-interests-of-creditors context) regarding a debtor's ability to manipulate such a test and make only nominal, if any, distributions to unsecured creditors. The Commission ultimately elected to retain a creditor's right to vote on an SME plan as a "check" on the proposed creditor allocations under the plan.

Finally, the Commission considered whether the pre-petition owners (*e.g.*, family owners, founders, entrepreneurs, etc.) should be able to retain their ownership interests post-confirmation. The Commissioners were persuaded by the witness testimony and other anecdotal evidence suggesting that the pre-petition owners' likely loss of their control and ownership deters SMEs from filing for bankruptcy. The Commission evaluated several ways to modify the absolute priority rule of § 1129(b) in a manner that would allow the pre-petition owners to keep any equity. Indeed, some Commissioners observed that such a result could enhance the post-confirmation success of some SMEs, as the pre-petition owners are often intimately involved with the business.[25] However, the Commission did not want this opportunity to come at the expense of unsecured creditors; rather, the notion was to allow nonconsensual confirmation if the SME could satisfy § 1129(b) for its secured creditors and provide a significant deferred economic return to its unsecured creditors.[26] The resulting "equity retention plan" would give an SME up to four years to pay off its unsecured creditors. The equity retention plan model would be the default rule and likely form the basis for the negotiation of consensual plans that could, for example, pay off unsecured creditors sooner, in different amounts, and in different forms of payment.

The ABI Commission's SME principles offer a new way — built on old and familiar concepts — to conceive SME reorganizations. The basic chapter 11 structure and the debtor-in-possession model remain, but the principles are intentionally nimble to allow the parties and the court to fashion a chapter 11 case that fits the particular debtor. A regional design studio does not run its business like a national retailer, and it should not be required to try to restructure like one. However, it should be given the same opportunity to use the federal bankruptcy laws to reorganize, maximize value for all of its creditors, and save as many jobs as possible. abi

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24 Section 1225 of the Bankruptcy Code defines disposable income as follows:

> (2) For purposes of this subsection, "disposable income" means income which is received by the debtor and which is not reasonably necessary to be expended —
>
> (A) for the maintenance or support of the debtor or a dependent of the debtor or for a domestic support obligation that first becomes payable after the date of the filing of the petition; or
>
> (B) for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business.

11 U.S.C. § 1125(b)(2).

25 The Commission discussed situations in which the pre-petition owners arguably have contributed to the debtor's financial distress. In such situations, creditors may use the estate-neutral appointment process to preserve the business or gain access to information. Alternatively, the case may warrant the appointment of a chapter 11 trustee. Moreover, any SME plan (whether or not a proposed equity retention plan) must satisfy the other requirements of § 1129 of the Bankruptcy Code.

26 For example, the SME principles propose using a limited-voting security, such as preferred stock or preferred units, to distribute 85 percent of the economic value of the reorganized debtor to unsecured creditors for the designated period, reserving 15 percent of the economic value and 100 percent of the voting control for the pre-petition equityholders. *See* Commission Report, Section VII.E.

By Karen Cordry[1]

Rethinking § 363 Sales: ABI Commission Steps Back from Brink

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There has been a long-running debate over the scope of "free and clear" sales under § 363. This article argues that the current approach has led to results that, like the coyote in the "Road Runner" cartoons, running right off the edge of the cliff. The ABI Commission to Study the Reform of Chapter 11's Final Report report, on the other hand, takes some welcome steps away from that cliff.[2]

Those steps off the cliff include cases such as *In re PBBPC Inc.*,[3] which held that a buyer may use a "free and clear" sale order to immunize it from its own future statutory *liabilities* for workers'-compensation premiums if the calculation of those liabilities takes into account in any way the fact that the buyer has taken over an existing workforce. In doing so, those cases reject the contrary analysis in *In re Wolverine Radio Co.*[4] and *In re Eveleth Mines LLC*[5] — and do so without ever explaining how a state's claim for the lost premium revenues owed by the *buyer* could ever be asserted as a claim against the debtor.

There are other aspects of recent sales, which — while less legally fraught — have caught the eye of many commentators. They note how far recent bankruptcy practice has diverged from the original paradigm of a struggling company given time to restructure its business and obtain the approval of its creditors for a reorganization plan in which there was shared pain for all, but the reward of creating a healthy entity that could return to the marketplace. Now, the details of a sale are worked out before the filing with a pre-selected buyer, most consideration is provided by the buyer's assumption of "cherry-picked" obligations to favored trade and employee interests, and disfavored creditors are left with a plan that divides up only a pittance of the actual cash — and even that plan process is giving way to "structured dismissals" where that final pittance is divided up outside the plan's structure. Again, each step seems logical, but when one looks back at the cliff face, it becomes apparent how far current cases have moved out into empty space.

Moreover, these prepackaged sales proceed at ever-greater speed, with judges being asked to schedule auctions as part of the first-day motions. While there is nominally competitive bidding, the compressed time period proposed for such sales drastically limits the ability of other bidders to effectively compete and for creditors to have an effective say in the process. The most breathtaking example of this trend was in *FCC Holdings Inc.*,[6] wherein the debtor asked the bankruptcy court to retroactively bless a sale that had taken place pre-petition. The court declined to do so, but the fact that such a proposal was made again shows how far over the edge of the cliff these cases have run.

In the "Road Runner" cartoons, the coyote only plummets to earth once he looks down and realizes where he is.[7] The ABI Commission's proposals recognize that current § 363 practices may well be in that moment of final suspended animation and suggest steps to pull the process back from the brink. Although there may be disputes over some of the details, the overall approach would improve the current situation in many ways, some of which will be touched on briefly below.

The Commission's first proposal[8] is that no auction of "all or substantially all of the debtor's assets" take place within 60 days after the petition date unless "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." This moratorium would give the other parties a breathing spell to evaluate the debtor's proposal. As Hon. **Wesley W. Steen** (ret.) noted in *In re Gulf Coast Oil Corp.*, "The Court must be concerned about a slippery slope. Not every sale is an emergency."[9]

The value of a statutory moratorium is that it takes the pressure off the court and creditors in the individual case to stand up to the coercion of the self-inflicted emergencies that have been created by pre-petition agreements among debtors and their secured lenders or proposed buyers. Motions to approve these sales always raise the specter of the "melting bananas," as Chief Justice John Roberts memorably remarked at oral argument in

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1 The views expressed herein are solely those of the author and not of the Attorneys General.
2 ABI Comm'n. to Study Reform of Chapter 11, Final Report and Recommendations (2014) (hereinafter, the "Commission Report"). The Commission Report is available at commission.abi.org.
3 467 B.R. 1 (Bankr. D. Mass. 2012).
4 930 F.2d 1132 (6th Cir. 1991).
5 312 B.R. 634, 654 (Bankr. D. Minn. 2004).
6 No. 14-11987 (Bankr. D. Del.).
7 The separate laws of physics applicable in cartoons were noted in "O'Donnell's Laws of Cartoon Motion," *Esquire* (June 1980). Those laws include "[a]ny body suspended in space will remain in space until made aware of its situation," and "[a]ny body in motion will tend to remain in motion until solid matter intervenes suddenly."
8 Commission Report at p. 83.
9 404 B.R. 407, 423 (Bankr. S.D. Tex. 2009).

the *Piccadilly* case.[10] However, as noted in *In re Humboldt Creamery LLC*,[11] "the problem with the 'melting ice cube' argument is that it is easy enough for the debtor to unplug the freezer prior to bankruptcy."

Yet, even if a judge sees the freezer cord in the debtor's hand on the first day, it is still very difficult to try to call the bluff of the debtor and its prepackaged partners. The ABI Commission would create a statutory backbone for the courts in such cases. As the proposal is drafted, the escape hatch standard remains too low. To ensure that debtors do not delay filing until the emergency has been created, the standard should require that the reasons for the claimed loss of post-petition value not be foreseeable pre-filing. It is one thing if one's factory burns down and shuts the company down overnight; it is quite another for a company to lose money for 15 straight quarters, file for bankruptcy, and then appear and declare that it needs an emergency sale. The Bankruptcy Code makes individual debtors plan ahead and obtain pre-petition economic counseling, despite a looming foreclosure. Sophisticated companies can do the same.

A second point in the ABI Commission Report is the proposed "redemption option value" concept.[12] This appeared to be related to the recognition that bankruptcy sales (both outside and as part of a plan) give buyers advantages compared to doing the same transaction outside of bankruptcy. These advantages include being able to override bulk sales laws, having transactions in several states resolved in a single order rather than multiple transactions, and having a sweeping court order to deal with recording and other transfer issues. All of these are above and beyond the ability to use that same court order to impose sweeping advance declaratory relief from successor liability in ways that may go far beyond state law. While none of these provisions changes the basic deal or the basic economics of the debtor's operations, the ability to use such provisions to ease the process and/or create liability exemptions that might not exist under nonbankruptcy law[13] is viewed as creating a "bankruptcy premium" for such sales.

There were suggestions during the Commission process that there might be some form of simple "surcharge" or "pay-to-play" approach whereby the senior creditors who would benefit the most from the "bankruptcy premium" would have to rebate a fixed portion of that premium back to the lower-level creditors in the case. However, the redemption option has moved away from that rather simple notion and uses a much more complicated approach to deal with the uncertainties in deciding how and when to value the company on a going-forward basis.

This is, to be sure, a substantial issue: There is the possibility that an inadvertent (or even intentional) miscalculation of value might end up providing a windfall to senior creditors at the expense of lower tranches. That possibility is exacerbated by the rush to complete early sales (which, as previously noted, is also dealt with in the Commission's proposal). Analyzing this proposal in detail is beyond the scope of this article, but it does appear that the simple "bankruptcy premium capture" concept is no longer being proposed. Under that approach, if everyone is dragged into a bankruptcy simply to allow the senior lender or the buyer to claim its special privileges, then those parties should be compelled to "give back" to those other constituencies. One of those special privileges is the trend toward providing ever-greater immunity from successor liability to buyers to an extent that the states would argue has run off the proverbial cliff with respect to the *PBBPC* line of cases.

> **[S]ince the use of § 363 to sell entire businesses would have been quite unusual in 1978, it seems likely that the drafters did not address successor liability for claims because it was assumed that such liability would be rarely, if ever, created by the expected sales of mere portions of a business.**

One argument has developed in this way: Abolishing successor liability is desirable because it is assumed that buyers will pay more if they receive that protection. If that is true, then the Bankruptcy Code must have been drafted to do that because its goal is to provide the highest return to creditors. If that is so, then § 363 *must* allow the courts to protect buyers from successor liability for claims by entering a "free and clear" sale order.

At that point, the analysis hits a road block because the term "successor liability" never appears in § 363, which only explicitly refers to ordering sales "free and clear" of "interests." That omission becomes more ominous when contrasted with § 1141, which clearly provides that a plan discharges the debtor of claims *and* interests. Moreover, the Bankruptcy Code frequently contrasts "claims" and "interests" and nowhere suggests that claims are a subset of interests. Rather, everywhere in the Code an "interest" is most naturally read as an *in rem* right, as contrasted with an *in personam* claim.[14]

To avoid the unthinkable possibility that a § 363 sale might not allow a buyer to avoid successor liability for claims, the courts have used brute force to expand the definition of an "interest" to cover claims.[15] While it was not the first such case, the most influential has been *In re TWA*.[16] In *TWA*, the court held that a buyer need not comply with an Equal Employment Opportunity Commission (EEOC) settle-

10 *See Fla. Dep't of Revenue v. Piccadilly Cafeterias Inc.*, 554 U.S. 33 (2008).

11 2009 WL 2820610,*2 (Bankr. N.D. Cal. Aug. 14, 2009).

12 Commission Report at p. 207. *See also* Donald S. Bernstein and James E. Millstein, "ABI Commission: Redemption Option Value Explained," XXXIV *ABI Journal* 6, 10-11, 57, June 2015.

13 The extent to which the Bankruptcy Code (as opposed to imaginative drafting by debtors) actually creates those added immunities is far from clear, as discussed herein, but buyers clearly enjoy the chance to dictate the scope of their own immunity and are assumed to pay more for that right.

14 Section 363(f) talks about an "interest in the [debtor's] property" and § 363(e) requires that "interests" receive adequate protection, but those with unsecured claims have no right to such protection. *See also Grupo Mexicano De Desarrollo v. Alliance Bond Fund*, 527 U.S. 308 (1999) (unsecured creditors do not have interests in defendant's property prior to obtaining judgment lien against that party).

15 The result-driven nature of this process can be seen in *Ind. State Police Pension Trust v. Chrysler LLC (In re Chrysler LLC)*, 576 F.3d 108, 125 (2d Cir. 2009), *judgment vacated*, 592 F.3d 370 (2d Cir. 2010) (court refused to accept argument drawn from difference in text; instead, it used desired result to reason away difference, stating that "[g]iven the expanded role of § 363 in bankruptcy proceedings, it makes sense to harmonize the application of § 1141(c) and § 363(f) to the extent permitted by the statutory language").

16 322 F.3d 283 (3d Cir. 2003).

continued on page 67

Affairs of State: ABI Commission Steps Back from the Brink on § 363 Sales

from page 21

ment giving flight attendants a number of stand-by vouchers to use for free flights. The court first held that an "interest" need not be *in rem*, since liens (which are *in rem*) are not the only form of interest. It then stated that an interest was instead any right that "*arise[s] from the property being sold*."[17] As it further explained, had the debtor not invested in airline property, it could not have created the claims against itself, and had the buyer not bought those assets, no successor liability could have been created. Thus, these settlement rights were interests that could be left behind in the sale.

The problems with that analysis are many. First, the fact that liens are not the only form of interest proves nothing since there are many other *in rem* rights (*e.g.*, ownership rights) that are interests and give meaning to § 363(f) without needing to add *in personam* claims. In addition, as to the other points, the Third Circuit suggested that its analysis encompassed only *some* claims and did not just subsume all claims into being "interests," but I challenge anyone to conceive of a claim, at least for a corporation, that does *not* arise from the business being sold in the broad sense used in *TWA*. By the same token, a buyer could also never have successor liability to begin with unless it bought assets from a debtor. If the fact of that purchase, standing alone, creates the "interest" that can be sold free and clear, then the limitation swallows up the whole. The very act that creates the liability (buying the assets) simultaneously is the basis for eliminating the liability. In short, this definition is a black hole that draws in every form of claim — and, if so, then why would Congress not have simply written § 363(f) to apply to both claims *and* interests?

So *TWA* doesn't make a lot of sense, but does this mean no sale outside of a plan can be free and clear of claims? The answer is "no," but *not* because of § 363(f). Rather, § 363 sales can be free of successor liability as to the vast majority of claims because under *nonbankruptcy* law, an asset-purchaser is not subject to such liability for the vast majority of claims. Since even the sale of entire businesses only creates successor liability in limited situations, the use of § 363 by a reorganizing debtor under the original chapter 11 paradigm to downsize and sell off portions of its assets would not be expected to engender such liabilities. In short, since the use of § 363 to sell entire businesses would have been quite unusual in 1978,[18] it seems likely that the drafters did not address successor liability for claims because it was assumed that such liability would be rarely, if ever, created by the expected sales of mere portions of a business. On the rare occasions where a sale could potentially create such liabilities, courts note that barring such claims is within the court's inherent powers for reasons having nothing to do with § 363(f).[19]

So, if under a proper analysis sales can be made free and clear of claims, does it matter how one gets there? The answer is "yes" for two reasons. First, if the Bankruptcy Code does leave the scope of successor liability to nonbankruptcy law, then arguments that recognizing any form of successor liability would "violate the Code's priorities" fall flat. Instead, the field is open for a reasoned debate about which such rights are of sufficient importance that a buyer — and the other creditors — should be forced to recognize them. Second, it means that the wholly amorphous definition of an "interest" that the Third Circuit created to shoehorn claims into § 363(f) is no longer necessary. Absent that wholly unbounded definition, it would also be far more difficult to argue that a buyer can claim an immunity from paying its own liabilities merely because their calculation has some connection to the assets it bought from the debtor.

The Commission Report[20] does continue to analyze these issues under the "interest" rubric, rather than simplifying matters by using an explicit "free and clear of *claims*" analysis, but its actual recommendations[21] do conclude that some forms of successor-liability claims and governmental regulatory authorities *should* be recognized. While one can debate the particulars of the choices the report makes, that is exactly the analysis that *should* take place. Let the arguments begin! abi

17 *Id.* at 290.

18 *See In re Lionel Corp.*, 722 F.2d 1063, 1066 (2d Cir. 1983) (court discussed controversy over whether such sales were illicit *sub rosa* plans).

19 *See In re White Motor Credit Corp.*, 75 B.R. 944, 948 (Bankr. N.D. Ohio. 1987).

20 Commission Report at p. 141.

21 *Id.* at p. 142.

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Legislative Update

By Donald S. Bernstein and James E. Millstein

ABI Commission: Redemption Option Value Explained

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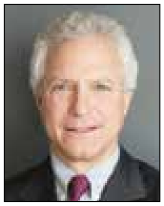

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The ABI Commission to Study the Reform of Chapter 11[1] has recommended several important changes that affect the treatment of secured creditors in chapter 11 cases. This article summarizes some of the Commission's key proposals affecting secured creditor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

Focus: The Timing of Valuations in Reorganization Cases

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

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

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

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

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

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

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

Recommendation: Redemption Option Value

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

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

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

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

4 Commission Report at pp. 83-87.

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

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

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

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

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

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

11 Commission Report at p. 221.

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

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

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

Implementation: A Topic for Further Study

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

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

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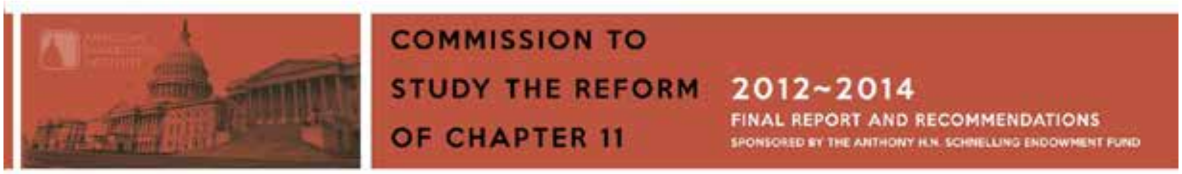
12 The Commission included an illustration of the calculation of redemption option value, showing the redemption option value at various levels of senior creditor recovery. *See* Commission Report at p. 222.

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

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

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



ABI Commission to Study the Reform of Chapter 11

Overview of
Recommendations and Findings

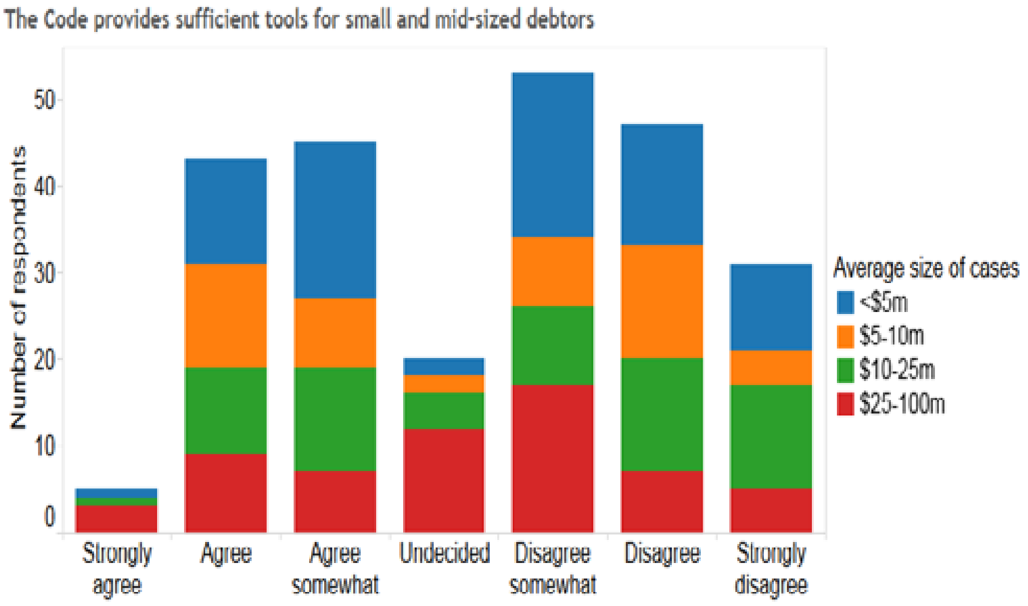
www.commission.abi.org

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

2

SMEs



3

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

4

SMEs

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%**	

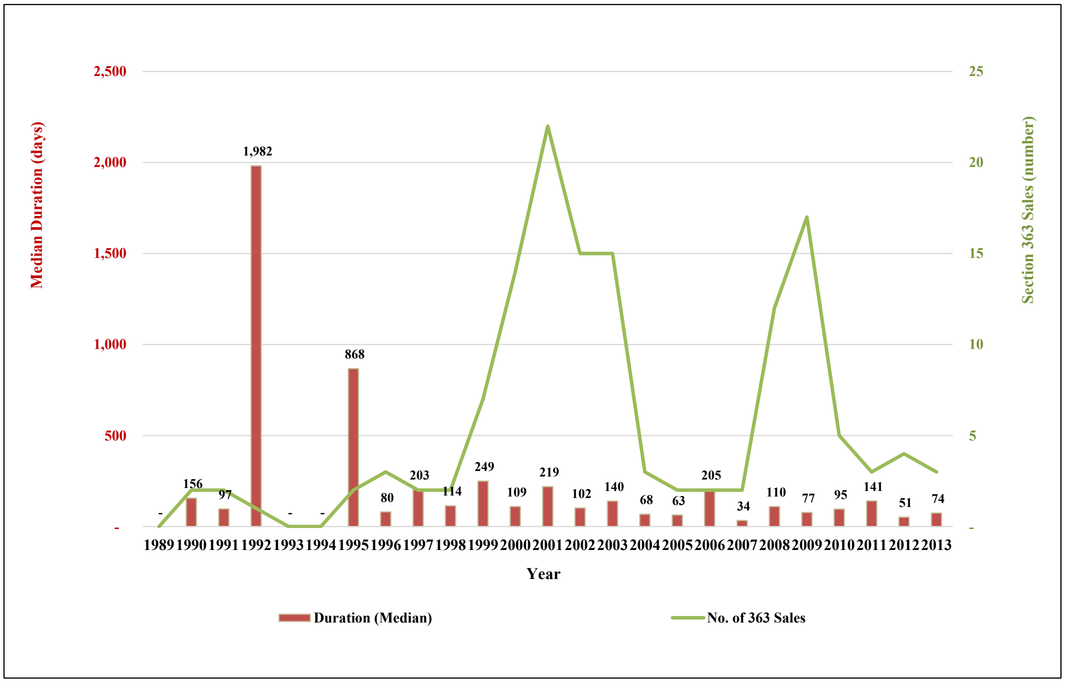
5

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

6

Going Concern Sales



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)

8

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

9

Certain Other Key Principles

- Proposed revisions to create more certainty in executory contracts, unexpired leases, and intellectual property issues
- New provisions regarding adequate protection, introducing concepts of foreclosure value and reorganization value
- Proposed revisions to the preference statute and certain aspects of the safe harbors
- New "estate neutral" concept
- Requirement for debtors to compile and, in certain circumstances, make available "Valuation Information Packages" or "VIPs"
- *And many more…*

10

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

11

Excerpts from the ABI Commission's Report on the Reform of Chapter 11

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.

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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).

American Bankruptcy Institute

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]hough 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

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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.").

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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 Constitution[115] 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.

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

B. Financing the Case

1. Adequate Protection

Recommended Principles:

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

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

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

- This formulation of adequate protection complies with the original purpose of section 506(a), which provides that value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a). Accordingly, the foreclosure value of a secured creditor's collateral should not necessarily determine the value of such collateral or the secured creditor's allowed claim for other purposes in the chapter 11 case.

- A secured creditor should continue to receive priority treatment under section 507(b) for the foreclosure value of its collateral at the time of its request for adequate protection under section 361. To the extent existing law has been interpreted by courts to mean that the secured creditor must be "provided" with adequate protection in order to gain this benefit, such case law should be overturned by statute. It is sufficient that the secured creditor be deprived of the requested relief from the automatic stay to implicate the protections of section 507(b).

- A court should be able to approve a provision to cross-collateralize a secured creditor's prepetition debt with the debtor's or the estate's postpetition property only for the purpose of providing adequate protection under section 361 and only to the extent that such cross-collateralization covers any decrease in the value of the secured creditor's collateral as of the petition date.

- The court should not approve any proposed adequate protection under section 361 that grants a lien on, or any direct or indirect interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code. Nevertheless, this prohibition should not limit the proceeds available to satisfy a prepetition secured creditor's claim arising solely under section 507(b).

Adequate Protection: Background

The filing of a chapter 11 case stays the enforcement of many creditors' actions against the debtor, including the collection and foreclosure actions of secured creditors. Moreover, following a filing, the debtor in possession[273] may continue to use its property, including any cash collateral, to operate its business and to facilitate its reorganization efforts. Although the debtor's right to the automatic stay and the continued use of its property ultimately benefit all stakeholders, the debtor's exercise of these rights directly affects the rights of secured creditors holding interests in the debtor's property. On the other hand, allowing a secured creditor to foreclose immediately on the debtor's property or to demand payment in full from the debtor would crater the debtor's reorganization efforts at the outset; such a provision would essentially turn chapter 11 into a liquidation statute.

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

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

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

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

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

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

276 11 U.S.C. § 361(1), (2), (3).

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

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

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

Adequate Protection: Recommendations and Findings

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

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

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

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

279 11 U.S.C. § 506(a).

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

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

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

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

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

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

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

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

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

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

The Commission also considered whether a debtor in possession should be able to grant a replacement lien in its chapter 5 avoidance actions or the proceeds of such actions to provide adequate protection to a secured creditor under section 361.[286] The Commission reviewed the original policies underlying the trustee's avoiding powers under chapter 5 of the Bankruptcy Code, including allowing the trustee to avoid prepetition transfers that preferred certain unsecured creditors and reallocating the

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

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

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

2. Terms of Postpetition Financing

Recommended Principles:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that —
  - o the postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor; and
  - o the court finds that the proposed postpetition financing is in the best interests of the estate.

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

- Subject to a 60-day restriction on milestones, benchmarks, and similar provisions (*see* Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*), a court should be able to approve, in a final order, permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364. For the definition of "permissible extraordinary financing provisions," see Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions.*

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

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 executoriness. 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 "executoriness" 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 executoriness 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 executoriness 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 executoriness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoriness issue and the attendant uncertainty and expense. The focus of the executoriness 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 executoriness 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 executoriness 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 executoriness. The Commissioners supporting this approach emphasized the value to such a clean solution: with the distraction of executoriness 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 executoriness 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 'executoriness' 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 executoriness 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 executoriness, 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 possession[428] 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 Bordewieck & 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 possession[441] 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 possession[452] 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).

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 not 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's[465] 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.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).

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.

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.

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 Depository 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); Grassmueck 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 & Lockhard 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

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.

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.

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class[762] benefiting from preserving the firm's value as a going concern in connection with a chapter 11 plan or section 363x sale (the "***immediately junior class***") should receive an allocation of value to recognize that the future possibilities of the ongoing firm include the possibility that such an immediately junior class might have been in the money or received a greater recovery if the firm had been valued at a later date.[763]

- In furtherance of this principle, except in small and medium-sized enterprise cases, an immediately junior class that might otherwise be permanently cut off from receiving value based on the reorganization value as of the effective date of the plan or the date of the section 363x sale order should be entitled to an allocation of value referred to as the "redemption option value" attributable to such class, as defined below. A distribution of redemption option value, if any, would be made to an immediately junior class to reflect the possibility that, between the plan effective date or sale order date and the third anniversary of the petition date (the "***redemption period***"), the value of the firm might have been sufficient to pay the senior class in full with interest and provide incremental value to such immediately junior class.[764] As explained below, the redemption option value in any given case may be negligible or non existent; it is not a percentage or fixed payment to junior creditors.

- In accordance with the above general principles, section 1129(b) should be amended to provide that, subject to the conditions described below,

  (a) a chapter 11 plan may be confirmed over the non-acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, attributable to such class, and

  (b) a chapter 11 plan may be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule

762 For purposes of applying these principles in connection with a chapter 11 plan when there is no sale of the firm, the relevant senior stakeholders are the class or classes of senior creditors receiving the residual interests (*e.g.*, equity securities) in the firm that will benefit from the firm's appreciation after the effective date of the plan. Generally speaking, outside the sale context (whether the sale is under section 363x or pursuant to a plan), a senior class paid in cash or solely in debt securities of the reorganized firm that receives no ongoing interest in the residual value (*e.g.*, equity) of the firm would not be required to share reorganization option value, which is intended to represent an allocation of value arising from the possibility of future appreciation in the value of the reorganized firm, with a junior class. How the principles would be applied when the residual interests in the firm are allocated among several senior classes is an issue that requires further development. In the context of a sale of substantially all of the assets of the firm, whether under section 363x or pursuant to a plan, the distribution to the immediately junior class would, generally speaking, be from the senior class's or classes' otherwise-applicable entitlement to the proceeds of the sale and would be made in cash or such other consideration that allocates the redemption option value to such immediately junior class from such proceeds.

763 In theory, this principle should apply to the allocation of the estate's value between senior and junior classes of creditors, whether the relative priority of their claims arises from liens, contractual subordination, or otherwise.

764 Because redemption option value is determined based on the presumption that the senior class, including any unsecured deficiency claims of the senior class if the senior class holds secured claims, is paid in full, under this principle the deficiency claims held by the senior class generally would not be entitled to share in redemption option value even if such a deficiency claim would be otherwise included in the immediately junior class.

treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class.

- Notwithstanding clause (a) above, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class.

- Similarly, except in small and medium-sized enterprise cases, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class.[765] If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.

- Based on these principles, even if an impaired senior class would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the section 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described above.
    - The "***redemption option value***" attributable to such immediately junior class is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price (as defined below) and a duration equal to the redemption period (as defined above).[766]
    - Generally speaking, the immediately junior class will be the class of stakeholders that would first derive material benefit from future increases in the reorganization value of the firm after payment in full of all senior classes receiving distributions under the plan. The immediately junior class

765 The Commission recognized that an individual creditor, several creditors, or the entire class could file objections to the sale. The Commission did not resolve the level of objection required, or whether an objection that was overruled by the court would preclude only that creditor's entitlement to any redemption option value.

766 Since this principle establishes a minimum recovery for the junior class where the class members have not objected to the section 363x sale, the reorganization value is fixed at the net value realized by the estate in connection with the sale. As noted below, the junior class can still dispute how the redemption option value is being calculated for such reorganization value (by presenting evidence on other components of the redemption option value calculation, such as volatility). On the other hand, if there is no section 363x sale, the junior class may contest the reorganization value under the plan, and trigger application of the absolute priority rule by rejecting the plan and in that context the junior class could assert the right to a portion of a higher reorganization value.

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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 rate[768] plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option.
- 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

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this analysis, including the secured creditors' rights under state law and the Fifth Amendment of the U.S. Constitution, and Congress's ability to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States" under the Bankruptcy Clause of the U.S. Constitution.[769]

The Fifth Amendment provides in relevant part: "No person shall be . . . deprived of life, liberty, or property, without due process of law."[770] Justice William O. Douglas notably explained that in bankruptcy, "[s]afeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that."[771] Commentators and practitioners have interpreted Justice Douglas's explanation in a variety of ways, with some suggesting that it means that a secured creditor is only entitled to the liquidation value of its interest in the debtor's property in bankruptcy, and others suggesting a broader meaning. Still another perspective is articulated by Prof. Tabb, who concludes that "a Fifth Amendment takings analysis simply is not helpful or indeed even applicable when considering the nature and scope of the protection constitutionally due to secured creditors in bankruptcy."[772]

The value of a secured creditor's interest in the debtor's interest in property is relevant at various points in the chapter 11 case. As explained above in the context of adequate protection, section 506(a) provides in relevant part that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."[773] The valuation of a secured creditor's claim thus involves at least two questions, both of which can provoke litigation: What is the appropriate valuation standard for the property included in the secured creditor's collateral, and what is the appropriate standard for determining the value of the secured creditor's interest in such collateral under that standard? It also can raise a third issue concerning the appropriate valuation methodology — *e.g.*, discounted cash flow, precedent sale transactions, and comparable company analysis.

Courts have taken different approaches to questions of valuation in chapter 11. Some courts suggest that liquidation value is always an appropriate standard for determining the value of the secured creditor's interest in collateral because the debtor is operating in bankruptcy. Other courts apply a liquidation standard when valuing claims in chapter 7, and a going concern standard in reorganizations under chapter 11 on the theory that the valuation should be based on how the collateral is being used. Still other courts struggle with whether a liquidation standard, if appropriate, should be analyzed on a forced-sale or orderly-sale basis. The uncertainty surrounding valuation issues generates both litigation and, arguably, consensual resolutions.

In the plan context, chapter 11 encourages consensual resolutions and permits parties to agree to distributions under a chapter 11 plan that may modify or otherwise affect their rights against the estate. Sections 1126 and 1129 codify this concept by providing that if the debtor proposes to impair the rights of a class of creditors or interest-holders under the plan and that impaired class accepts

769 U.S. Const. art. I, § 8, cl. 4.
770 *Id.* amend. V.
771 Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 278 (1940).
772 Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *1 (arguing that the "Fifth Amendment Takings Clause does not and should not constrain the power of Congress to modify the substantive rights of secured creditors under the Bankruptcy Clause.").
773 11 U.S.C. § 506(a).

the plan, the proposed treatment of the claims or interests is permissible even if it provides those creditors or interest-holders with arguably less than otherwise required.[774] If an impaired class of claim- or interest-holders, however, does not accept the plan, the debtor can impose the proposed treatment on the class only if the plan satisfies the cramdown provisions of section 1129(b) of the Bankruptcy Code, including the absolute priority rule.[775]

The absolute priority rule as applied under Section 1129(b) in essence provides that a dissenting class of creditors must be paid in full before junior creditors or interest-holders may receive any distributions under the plan. The rule originates from the railroad equity receivership cases in the early 1900s and the U.S. Supreme Court's decision in *Northern Pacific Railway Co. v. Boyd*.[776] In that case, the railroad company reorganized by selling itself to bondholders and equity security holders and providing no distributions to junior creditors. The Supreme Court rejected this scheme and held that "[i]f the value of the [rail]road justified the issuance of stock exchanged for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control."[777]

The absolute priority rule codified in section 1129(b) is a variation of the rule announced by the Supreme Court in *Boyd*, but it continues the basic tenet that priority matters — *i.e.*, secured creditors have a right to receive payment in full prior to junior creditors and interest-holders receiving any value. Section 1129(b) also articulates an application of the absolute priority rule for secured claims, which preserves those payment rights in the waterfall payment scheme of a chapter 11 plan. As one commentator noted shortly after the enactment of the Bankruptcy Code, "the [absolute priority] test for secured claims is completely novel, affording protection for classes of secured claims that is not provided under present law."[778]

The absolute priority rule is an important creditor protection in chapter 11 cases, but it also has proven to be inflexible and often a barrier to a debtor's successful reorganization. It also can allocate value among creditors in an arguably random manner depending on the timing of the value realization event — *i.e.*, plan confirmation. For example, to the extent that a plan is confirmed during a downturn in the economy generally or the debtor's industry more specifically, the valuations used to support the plan distributions may value the reorganized entity at a low point in the valuation cycle. Creditors may not have an appetite for, or the debtor may not have the financial ability to, continue to operate in chapter 11 until the valuation improves, or the debtor may not have the ability to offer adequate protection to secured creditors for the use of cash collateral or to obtain DIP financing, which may limit (or allow the secured creditor to limit) the duration of the case. Accordingly, under the absolute priority rule, junior creditors and interest-holders may lose their rights against the estate and receive no value on account of their claims simply because of the timing of the valuation of the enterprise in the chapter 11 case, while secured creditors, whose rights outside of bankruptcy

774 *Id.* §§ 1126, 1129(a).
775 *Id.* § 1129(a), (b). For a discussion of the "no unfair discrimination" requirement of section 1129(b), see Section VI.B, *Approval of Section 363x Sales*.
776 N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).
777 *Id.* at 507–08. *See also* Ecker v. W. Pac. R.R. Corp., 318 U.S. 448 (1943); Marine Harbor Props., Inc. v. Mfrs. Trust Co., 317 U.S. 78 (1942); Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 520 (1941); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 122 (1939) (noting that *Boyd* adopts an absolute priority rule).
778 Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, *supra* note 759, at 143 (citations omitted).

would have been limited to foreclosure, get the benefits of the chapter 11 case and the exclusive right to the future possibilities of the firm as a reorganized going concern.

Notably, similar valuation and distribution issues may arise in the context of a sale of all or substantially all of a debtor's assets under section 363(b) and proposed section 363x under these principles. Although the price being offered for a debtor's assets in a section 363 sale arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale, or economic or industry factors are negatively impacting valuations, the debtor's estate may be monetized at value far below what the estate could be worth at a later date to the prejudice of stakeholders lower in the pecking order of priorities. The arguable unfairness of this result is potentially intensified when the secured creditor is the purchaser of the assets, for example using a credit bid, and is able to capture the future increments in value solely for its own benefit.

Creditors' Rights to Reorganization Value and Redemption Option Value: Recommendations and Findings

Throughout their deliberations, the Commissioners held lengthy and thoughtful discussions concerning the rights of senior creditors in bankruptcy and how best to balance these rights with the reorganization needs of the debtor and the interests of other stakeholders.[779] The Commissioners analyzed changes and trends in the secured lending industry and financial markets generally.[780] They considered credit pricing and its relation to collateral valuations and risk assessments.[781] And they reviewed the literature representing all sides of these issues, including the commentary and studies on the perceived increase in senior creditor control in chapter 11 cases.[782]

779 *See Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the importance of secured creditors' rights and the need for certainty for the capital markets when debtors are in bankruptcy), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (stating that secured creditors need certainty that their prepetition contractual agreements will be upheld in bankruptcy and that significant changes to this certainty will cause the cost of credit to increase), *available at* Commission website, *supra* note 55.

780 *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Oct. 17, 2012) ("The primary leveraged loan market has grown dramatically in the last 10 to 15 years."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("Secured lending is a critical part of the capital markets, particularly for non-investment-grade borrowers. Indeed, virtually 100% of leveraged loans are secured, and secured debt makes up 50% of the leveraged finance market as a whole."), *available at* Commission website, *supra* note 55.

781 *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 7 (Oct. 17, 2012) ("Senior secured loans sit atop the capital structure of corporations — situated above high yield bonds, convertible securities, preferred stock, and common stock — and offer corporate America a private and cheaper source of funding than would otherwise be available. Because of the senior secured nature of leveraged loans, and the protections afforded to secured lenders, investors are willing to accept a far lower yield on their investment. For example, over the last three years, leveraged B-rated loans have been priced in the primary market — that is, they yield — approximately 200 basis points less than B-rated unsecured bonds, with this substantial savings (25%) passing directly to the borrower."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("By providing collateral for a loan, borrowers have the option of providing their lenders with a lower-risk basis on which to extend credit, in exchange for which the borrower obtains capital at a lower price. Indeed, non-investment-grade borrowers essentially have no access to the unsecured loan market, and absent secured loans, would be forced to issue high-yield bonds or risk being shut out of access to the capital markets altogether. Borrowing on an unsecured basis at extraordinarily punitive interest rates — or being denied credit altogether — may do far more harm to a company than borrowing at more reasonable rates on a secured basis."), *available at* Commission website, *supra* note 55.

782 *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (June 4, 2013) (noting that the adequate protection rules are increasingly resulting in retailer liquidation because substantially all of a distressed retailer's assets are subject to prepetition liens and because of the adequate protection provision, debtors may not use or sell their assets without the lender's consent; and lenders are not consenting), *available at* Commission website, *supra* note 55. *See generally* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 523 (2009); Barry E. Adler, *Bankruptcy Primitives*, 12 Am. Bankr. Inst. L. Rev. 219, 239 (2004) ("Chapter 11 is not for every firm, and the Bankruptcy Code should not permit chapter 11 to be an option for a debtor with a

As discussed more fully in the context of adequate protection above, the Commissioners recognized the competing interests at stake and that the extreme position on either the pro-senior creditor or the pro-residual stakeholder side was not in the best interests of chapter 11 or the bankruptcy system. They strived to reach an appropriate balancing of these interests to the greatest extent possible. That balancing provides for valuing a senior creditor's collateral at (i) foreclosure value (as defined in these principles) for purposes of adequate protection, and (ii) reorganization value (as defined in these principles) for purposes of distributions in the case. The Commissioners believed that this balance would enhance a debtor's ability to obtain much-needed liquidity early in the case while allowing the senior creditor to benefit from the reorganized debtor's continued use of collateral in the ongoing business by receiving the value of its collateral on an enterprise or going concern basis later in the case. They also found that it comported with the mandate of section 506(a) that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[783]

The definition of reorganization value in these principles is designed to capture the total enterprise value of the firm, including value generated through the chapter 11 case. Subject to the principles regarding redemption option value described below and the courts' powers under sections 506(c) and 552(b), as described in Section VI.C.3, *Section 506(c) and Charges Against Collateral* and Section VI.C.4, *Section 552(b) and Equities of the Case*, the principles further provide that a senior creditor should be entitled to receive the reorganization value of its collateral under a chapter 11 plan or in a section 363x sale.

The Commission received substantial testimony on the allocation of value in chapter 11 cases. Several witnesses posited that chapter 11 cases were being run for the benefit of the senior creditors and generating little, if any, value for other creditors.[784] Commentators have also observed this trend.[785]

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corporate charter that provides an alternative process in the event of default."); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1211 (2006) (discussing increased role of creditors in chapter 11 process); David A. Skeel, *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917, 918 (2003) ("Whereas the debtor and its managers seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast."). *But see* Westbrook, *The Role of Secured Credit in Chapter 11 Cases*, *supra* note 750, at *1 (forthcoming 2015) (stating that "secured creditor control is less pervasive than has been asserted").

783 11 U.S.C. § 506(a).

784 *See, e.g., Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Oct. 26, 2012) (NCBJ Transcript) ("I think what you've got today is that because of the move from being unsecured creditor status to secured creditor status, which is happened over the last number of years that I've been in the business, it's increased the leverage of the secured creditors and thus reduced the flexibility of a rehabilitation during this process."), *available at* Commission website, *supra* note 55; *Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) ("Over the years the secured lenders have increased their control over the company during the pre-petition period by taking dominion of the cash via lockbox sweeps; and requiring strict budgets and forbearance agreements. These actions enable the secured creditor to significantly increase their control over borrower cash and ultimately over a Chapter 11 filing should the borrower choose to go that route."), *available at* Commission website, *supra* note 55; *Written Statement of Jim Millstein, Chairman of Millstein & Co.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Apr. 19, 2012) ("[B]y virtue of the significant protections afforded secured debt under Chapter 11, sophisticated creditors take pains to structure their credit extensions in secured form when lending to companies in distress. As a result, in cases where the aggregate amount of secured debt exceeds the going concern value of the enterprise, a Chapter 11 reorganization has become little more than a court-supervised assignment for the benefit of creditors."), *available at* Commission website, *supra* note 55; *Written Statement of Clifford J. White, Director, Executive Office for the U.S. Trustees: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2012) (describing how DIP lending conditions often ultimately control the fate of the debtor), *available at* Commission website, *supra* note 55; *Oral Testimony Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Oct. 17, 2012) (LSTA Transcript) (noting that secured creditors have great influence over DIP lending terms), *available at* Commission website, *supra* note 55. *See also* Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *3–4 ("One of the most notable developments in chapter 11 reorganization practice in this millennium is the dramatic expansion in the power exercised by secured creditors. Financing has experienced a sea change, and today many firms enter chapter 11 with their assets full (or almost fully) encumbered. The reality then is that the entire reorganization is dependent on the good graces of the prebankruptcy controlling secured lender. That means that important stakeholders — bondholders, trade creditors, tort victims, employees, and shareholders, to name but a few — are excluded from any recovery but for the whims of the controlling secured creditor.").

785 *See, e.g.,* Jacoby & Janger, *Ice Cube Bonds*, *supra* note 283, at 922–23 (discussing lender control exerted over timing of sales through postpetition financing and blanket liens); Anthony J. Casey, *The Creditor's Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759, 760 (2011) ("A secured creditor, exercising control over the debtor firm, determines that

Similarly, witnesses expressed concerns regarding the lack of a debtor's equity in its property at the commencement of its case and the challenges presented to restructuring the debtor under these circumstances.[786] The Commission also heard testimony concerning how the timing of a chapter 11 case — and the value realization event in the case (*e.g.*, plan confirmation or sale approval) — can impact value allocations among creditors, and also how capital structures overwhelmed by secured debt and a resulting difficulty in obtaining postpetition financing to continue operations are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales.[787]

The Commissioners debated both the underlying premises in this testimony, as well as possible ways to address the concerns.[788] The Commissioners noted the increasing concerns among commentators and practitioners regarding administratively insolvent chapter 11 cases, structured dismissals, and issues regarding value allocation in chapter 11 cases.[789] They observed that in the recent cycle of chapter 11 cases, the fulcrum security (*i.e.*, the priority level of the class of debt in the debtor's capital

a bankruptcy filing to facilitate such a sale is the optimal strategy for the distressed firm. The debtor then files, and the sale is accomplished").

786 *See Written Testimony of Michael R. ("Buzz") Rochelle: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 22, 2013) ("Today the newly-filed debtor is already under water; the secured lender is under-secured; and use of cash collateral generally comes with concessions that tighten security documentation and tie the debtor to a short-term budget which allows for little but locating an asset purchaser."), *available at* Commission website, *supra* note 55; *Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3, 4–5, 6 (Nov. 3, 2012) (stating that secured creditors have often "liened up" all the debtor's assets prior to the bankruptcy, hurting the debtor's chance at rehabilitation), *available at* Commission website, *supra* note 55. "Lenders providing postpetition financing no longer do so in order to make good returns with assured repayment, or protect their prepetition positions by getting collateral for previously unsecured loans. Instead, they often do so in order to take control of the debtor, through covenants, deadlines, and default provisions." *Id.*

787 *See, e.g., Written Statement of Professor Anthony J. Casey: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 7, 2013) ("On the other hand, the secured creditor may exercise its foreclosure and liquidation rights when the debtor defaults. But that liquidation cuts off the future of the assets as part of a going concern. Thus, the secured creditor's claim on going concern is extinguished along with the junior creditors' claims. The secured creditor essentially has two options: take the liquidation value or keep the firm alive subject to the junior creditors' claims."), *available at* Commission website, *supra* note 55; *Written Statement of Sandra E. Horowitz: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Feb. 21, 2013) ("Finally, a third challenge confronting creditors' committees is the growing use of quick Section 363 asset sales, a situation that can undermine their efforts to maximize recoveries for general unsecured creditors. While I recognize that a sale can be viewed as the real value of the estate and the only viable option, I would argue that this alternative can benefit the DIP lenders and possibly other secured creditors to the complete detriment of the unsecured credits who may well benefit from a classical operational and financial restructuring from which value can ultimately be realized."), *available at* Commission website, *supra* note 55.

788 Notably, the Commission also received and considered at length testimony on the value of secured credit in bankruptcy and the important role markets play in providing liquidity to distressed companies. *See, e.g., Oral Testimony of Elliot Ganz: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("There are two things that are especially important to the smooth functioning of the market, legal clarity and financial liquidity. First, lenders and investors need to know what the rules are prior to entering into a transaction. They need to have the confidence that the rights they've bargained for will be respected and enforced. Second, they need to know that they have the ability to sell their positions, especially when things go south."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2-3 (Oct. 17, 2012) ("Secured credit is also vital when the capital markets constrict, as they did just a few years ago in the aftermath of the 2008 financial crisis. At that time, when leveraged markets were barely functioning, investors were extraordinarily (and understandably) careful about investing in non-investment-grade debt. At the same time, due to the economic downturn, many companies were facing challenges to their businesses and needed capital just as the markets were freezing up. For a very large number of those companies, the solution was to access the secured debt markets."), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[L]essening the protections accorded secured creditors would affect loan sizes going forward. Lenders would not be willing to lend as much if they cannot be sure that they will be able to collect as much as they are owed or the value of their collateral in the event of default."), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 15, 2012) ("Asset-based financing extended by CFA members has played an important role in financing the growth of U.S. companies for many decades. It allows companies the opportunity to obtain the working capital they need to operate and grow, and create jobs, and also provides financing for capital expenditures and the acquisition of other companies."), *available at* Commission website, *supra* note 55. Throughout deliberations — on all issues — the Commission worked to balance competing interests and perspectives.

789 *See, e.g.,* Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, Am. Bankr. Inst. J., Mar. 2011, at 20; Bruce S. Nathan & Bruce D. Buechler, *Who Pays the Freight? Interplay Between Priority Claims and a Debtor's Secured Lender*, Am. Bankr. Inst. J., Nov. 2011, at 26; Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative after Asset Sales*, Am. Bankr. Inst. J., June 2010, at 1; Charles R. Sterbach & Keriann M. Atencio, *Why Johnny Can't Get Paid on His General Unsecured Claims: a Potpourri of Lingering Abuses in Chapter 11 Cases*, 14 J. Bankr. L. & Prac. 1, Art. 3 (2005).

structure at which the firm's enterprise value is exhausted at the time of the enterprise valuation in the case) was higher in the debtor's capital structure than in the past. Although in 1978 the fulcrum security was almost always general unsecured claims, in more recent cycles, the fulcrum security was increasingly often at the senior creditor or subordinated senior creditor level.[790]

The Commissioners discussed the potential reasons for this trend, including the testimony from the lending community on these issues.[791] They acknowledged the potential role of various confounding factors such as economic cycles, lending practices, delay in commencing chapter 11 cases (which can be facilitated by the economic cycle and the availability of cheap money, as well as a management's resistance to a filing), outdated or underperforming business models, ineffective management, and other market or constituent pressures. They also recognized and discussed the arguments of commentators and practitioners who believe that value allocation and creditors' recoveries should remain relatively unchanged and are appropriate given parties' state law rights.[792] The Commission

790 *See, e.g., Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 22 (Oct. 26, 2012) (NCBJ Transcript) ("If you just looked at the Lehman example, you see that at the 11th hour, various sophisticated creditors went from unsecured status to secured status and, in fact, used the safe harbors to the tune of $17 billion. The answer is more sophisticated the creditor, in this case, would be your banker. Your banker has an opportunity to take advantage of all other classes of creditors by moving effectively from unsecured status to secured status. That's happened in Lehman, and it happens every day."), *available at* Commission website, *supra* note 55; *Written Statement of Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 15, 2012) ("In the middle market cases, it is the secured debt that is the fulcrum credit."), *available at* Commission website, *supra* note 55. *See also* Christie Smythe, *"Fulcrum" Deals Rising to Prominence, Experts Say*, Law 360 (Oct. 9, 2009, 1:26 PM) ("While in the past fulcrum securities were generally unsecured bonds, secured bonds have also become fulcrum securities in some recent bankruptcy scenarios as a result of the lending practices before the credit crisis, experts said."), *available at* http://www.law360.com/articles/122360/fulcrum-deals-rising-to-prominence-experts-say.

791 *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 10 (Oct. 17, 2012) ("During the financial crisis of 2008-2009, primary markets for both leveraged loans and high yield unsecured bonds seized up (illustrated on Slide 6). Importantly, the senior secured high yield bond market increased dramatically to take up some of the slack, providing crucial liquidity that was otherwise unavailable. In 2007, leveraged lending volume plunged from $535 billion to $152 billion and $76 in 2008 and 2009, respectively. Similarly, unsecured high yield bond volume fell from $143 billion in 2007 to $68 billion in 2008, before recovering to $163 billion in 2009. Despite the precipitous decline in leveraged loans and unsecured high yield bonds, secured high yield bond volume moved to fill the void in 2009, with issuance of $60 billion, a ten-fold increase from 2008, and a four-fold increase from 2007, when respective volume was $6 billion and $15 billion."), *available at* Commission website, *supra* note 55; *Oral Testimony of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 28 (Oct. 17, 2012) (transcript) ("What I would say is, we've definitely seen an increase in percentages of debt raised in the high-yield bond that's secured, so you're probably talking about 25% of the high-yield bond market having any kind of security around it back in '06. Today you're in the low 30s, and we peaked about 34–35% number, so it definitely picked up by about 10% during that period of time, and it was noticeable because the debt overall in the bond market was down then, so it felt like there were so many bond issuers in there, and there were because that was how you raised capital. . . . I would say that the other side of that equation was there was no loans being issued for the most part, so the secured bonds in no way filled the hole that was left behind by the loans that were not being raised. The loan market has been recovering pretty steadily, more or less, for the last three years now, but I don't know that we are back to where we were in that Golden Day of the CLO."), *available at* Commission website, *supra* note 55.

792 *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Oct. 17, 2012) ("Since bank loans are typically the most senior debt in a company's capital structure, and generally have first lien claim to a company's assets in the event of bankruptcy, they fare far better upon default than other indebtedness. Moreover, that level of recovery has stayed remarkably consistent over the last four credit cycles. According to an analysis by Moody's Investor Services, which tracked more than 1,000 corporate defaults since January 1987, average recoveries for bank loans were approximately 80 cents on the dollar, compared with recovery of less than 50 cents on the dollar for senior unsecured bonds and 30 cents on the dollar for subordinated bonds."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[F]ocusing only on the debtors that fail to reorganize in chapter 11 ignores the far greater number of companies who avoid bankruptcy entirely, and instead develop their businesses and create jobs, because they are able to access low-cost, secured credit. The ability to pledge collateral is particularly vital to both healthy non-investment-grade and financially distressed companies. In both cases, the security interest is a critical tool in reducing the cost of credit, and in many cases is a necessary condition to the extension of credit at all. Without the ability to offer an enforceable security interest, non-investment-grade borrowers may lack sufficient access to the capital markets."), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("[B]ankruptcy reforms will not affect bankruptcy alone. Weakening the protections available to secured creditors, or reducing the recovery of holders of debt bought on the secondary market, will have a profound, and negative, effect on the availability and price of credit — particularly credit extended to non-investment-grade companies."), *available at* Commission website, *supra* note 55; *Oral Testimony of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Oct. 17, 2012) (transcript) ("If you look at capital structures 10 years back and the ratios of senior secured debt to subordinated debt I would suspect that, in general, that those capital structures are not dramatically different."), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the*

ultimately concluded that trying to isolate the cause was futile and that a better approach would be to explore ways to enhance the value allocation rules and distribution mechanisms in chapter 11 so as to continue to protect the rights of senior creditors, protect junior creditors against being cut off entirely from the future possibilities of the firm based on a valuation at a single moment in time and based on other factors that may be outside of the debtor's control, and incentivize the major parties to reach a consensual reorganization if the underlying economics justified the debtor's emergence as an ongoing enterprise.

The Commissioners worked extensively to identify ways to achieve these goals. The Commission generally agreed that the timing of a judicially supervised reorganization in the life cycle of the credit markets generally and in the business life cycle of a given company should not dictate hard and fast distributional rules that advantage the creditors who happen to be in the senior position at a given moment in time. The Commissioners discussed this basic premise at length and the concept that a valuation date set by the effective date of a plan or the date of a section 363x sale order should not cut off all future possibilities associated with the affected assets for a junior class that appears to be significantly impaired or out of the money on the plan or sale valuation date. Accordingly, the Commission determined to recommend the following overarching principle: the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be, which would enable junior creditors to "redeem" in full the allowed claim of the impaired senior creditors receiving the reorganization value of the company under such plan or sale.

Under this principle, even if an impaired class of senior creditors would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described in the principles above.[793] Specifically, a chapter 11 plan may be confirmed (a) over the non-acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, applicable to such class, and (b) over the non-acceptance of a

Reform of Chapter 11, at 3 (Nov. 15, 2012) ("If the Commission ultimately proposes reducing the rights of secured lenders in Chapter 11, then it is our organization's view that anything short of allowing secured lenders the ability to obtain the benefits provided under their pre-chapter 11 loan agreements in Chapter 11 will have the direct effect of increasing our members' risk analysis which will result in increasing the cost of credit and reducing the amount of credit extended to SME borrowers who seek relief under Chapter 11."), *available at* Commission website, *supra* note 55.

793 For a thoughtful analysis of "option" value in chapter 11 cases, see Casey, *supra* note 785 (explaining value distortions created by the creditors' bargain and strict adherence to the absolute priority rule, and proposing a creditors' call option to address such valuation distortions). *See also* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1936 (2006) ("The presence of valuation uncertainty can, by itself, give option value to the claims of junior creditors even when they are, in expectation, out of the money.") It should be noted that Professor Casey talks about preserving secured creditors' nonbankruptcy foreclosure value. *See* Casey, *supra* note 785, at 789 ("The creditors'-bargain model requires a distributional rule that — while respecting nonbankruptcy contract rights — maximizes the aggregate pool of assets in bankruptcy. This means protecting the secured creditor's right to nonbankruptcy foreclosure value and the unsecured creditor's call option, while allocating bankruptcy rights in a way that creates the optimal incentives for the creditors. The proposed Option-Preservation Priority does precisely that."). The Commissioners debated the "foreclosure" vs. "reorganization" value issue at length and the Commission determined that, as part of the overall compromise reached in the principles, if a plan is confirmed or a sale is approved, secured creditors should be permitted to receive the reorganization value of their collateral, which could be greater than the nonbankruptcy foreclosure value.

senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class. Notwithstanding the foregoing, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class. Similarly, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class. If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.

The Commission agreed that the principles governing redemption option value in chapter 11 cases should not apply to cases involving small and medium-sized enterprises. The Commission believed that further study and development of the principles would be needed to determine whether they could be applied in a cost-effective and meaningful manner in such cases. The Commission proposed separate principles governing confirmation of chapter 11 plans in small and medium-sized enterprise cases, in Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

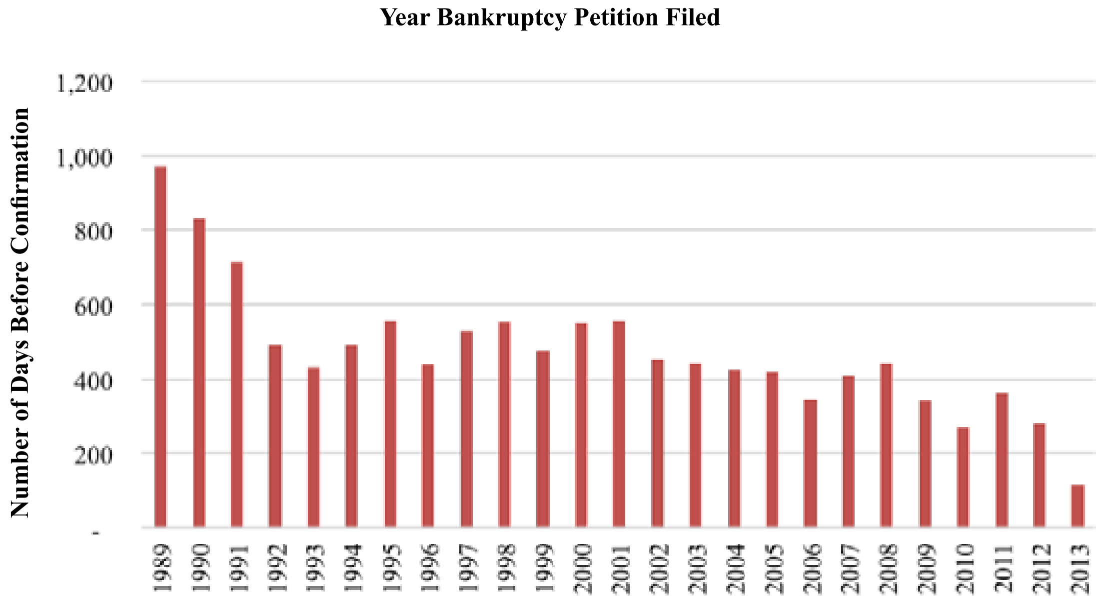
In developing these principles, the Commissioners discussed, debated, and refined several key concepts necessary to determine whether distributions to stakeholders should be adjusted due to the possibility of changes of the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be. The Commission concluded that the redemption option value attributable to the immediately junior class should be the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period. Notably, value distributed to the immediately junior class under these principles need not be, and in most cases likely would not be, in the form of an actual option. The requirement is that the requisite *value* be distributed to the immediately junior class, regardless of form.

Although a relatively straightforward concept in a simple capital structure (see example below), the Commissioners recognized the potential complexities of applying these principles in more involved corporate and financing structures. Accordingly, the Commissioners strived to identify principles that define the basic parameters of junior creditors' rights, with the expectation that there would be further development of the appropriate mechanisms for applying the principles in more complex cases. Indeed, the principles set forth above are not intended to alter the order of creditor priorities or to affect allocations within a particular class of creditors; rather, the principles speak generally to how courts should determine whether the value of the debtor or its assets is sufficient to support a distribution to the immediately junior class. The Commissioners acknowledged that, in implementing the redemption option value concept, the mechanism invoked by the parties and the courts will likely require further development to determine whether and how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value (for example where it is secured by only some of the assets of the firm), where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all senior classes are receiving distributions in the form of interests in the residual value of the firm, where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full.

In their discussions of redemption option value, the Commissioners methodically examined various formulas and procedures for addressing the potential deficiencies in chapter 11 valuations based on the timing of the effective date of the plan or the date of the section 363x sale order. For example, in a simple capital structure, the Commissioners considered the following factors and steps appropriate, and they are set forth here solely for purposes of illustration:

- *First*, the Commissioners analyzed the problem at hand — *e.g.*, timing can cause the value realization event to allocate value among creditors at a historically low valuation. The Commissioners examined the economic and financial literature and determined that most economic cycles, industry events, operational issues, etc. resolve themselves in approximately three to five years. Recognizing the need for parties to have certainty as soon as possible in the distribution context and despite strong arguments from some Commissioners for five years, the Commission decided to recommend using, as the expiration date of the exercise period for the hypothetical redemption option, a date that is three years from the petition date. Based on several factors, including the factors discussed above and the average duration of chapter 11 cases as shown in the chart below, the Commission found that determining ***redemption option value*** based on a hypothetical option expiring at the end of such a three year period (the ***redemption period***) should be sufficient to redress the potential unfairness of permanently crystalizing the value of the firm as of a single plan confirmation date or sale date.[794]

794 Mr. Shrestha prepared this chart for the Commission based on data from the New Generation's Public and Major Private Companies Database. Accordingly, it was limited to public and large private companies. The duration above is from the petition date to the date of the confirmation order. In recent years, the mean and median durations for chapter 11 reorganizations (from petition date to confirmation) are respectively: 2009 (342, 275); 2010 (269, 206); 2011 (360, 338); 2012 (281, 274); 2013 (116, 108). *See generally supra* note 65 and accompanying text (generally discussing limitation of chapter 11 empirical studies).



Duration Between Bankruptcy Filing and Confirmation Order

- *Second*, the Commissioners evaluated different ways to calculate the redemption option value — *i.e.*, the potential value allocation to the immediately junior class at the time of the value realization event. After much debate, including discussion of concerns of some of the Commissioners that an option valuation methodology was not a good fit for the redemption concept, the Commission concluded that using a market-based method such as the Black-Scholes model purely as a working formula would likely be the best way to consistently and accurately determine the value of the hypothetical redemption option. Traditionally, a Black-Scholes model uses four factors to value an option: the strike price of an option, the term of the option, volatility, and the risk-free rate. In the context of calculating any ***redemption option value,*** (i) the strike price is 100 percent of the ***redemption price*** described above (*i.e.*, senior class or classes must be repaid in full before any redemption option value exists), (ii) the term of the option would expire three years from the petition date (*i.e.*, the ***redemption period***); (iii) volatility could vary but can be determined for a particular debtor by looking at the historical volatility of comparable companies, using an agreed upon volatility rate, or using a set metric like the average 60 day forward volatility of the S&P 500 Index for the past four years (*i.e.*, approximately 15% at the time of this Report); and (iv) the risk-free rate generally is based on the U.S. Treasury rate.[795]

- *Third*, the Commissioners tested the rule using the agreed upon calculation formula under a variety of scenarios. For example, if the senior class is entitled to the entire value of the firm and is determined to be receiving 50 percent of the principal amount of their

795 The Black-Scholes formula or similar methodologies could identify the redemption option value once these four factors are identified and the percentage recovery of the secured creditors based on the reorganization value of the firm is determined as of the plan confirmation or section 363x sale order date. The Binomial Options Pricing Model, Monte Carlo options models, and other formulas may have to be considered where Black-Scholes is not effective to value an option on a particular enterprise.

claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)) based on the reorganization value of the firm on a plan confirmation date as specified in the plan, and the confirmation date occurs one year after the petition date, the ***redemption option value*** likely holds no value for the immediately junior class under reasonable assumptions. Specifically, this result occurs with a 50 percent recovery to the senior class; a "strike" price (the ***redemption price***) of 100 percent (payment in full to the senior class); a ***redemption period*** of two years (confirmation date one year after the petition date); a volatility rate of 15 percent; and a risk-free rate of 2.23 percent. If you change the percentage recovery of the senior class to 90 percent, meaning that the reorganization value of the firm is sufficient to repay the senior creditors 90 percent of the principal amount of their claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)), the redemption option value (under the previous assumptions) is approximately 5 percent of the reorganization value, which would be distributed to the immediately junior class. Specifically, this result occurs with a 90 percent recovery to the senior class; a "strike" price (the ***redemption price***) of 100 percent (payment in full to the senior class); a ***redemption period*** of two years (confirmation date one year after the petition date); a volatility rate of 15 percent; and a risk-free rate of 2.23 percent. The following chart depicts these results:

Redemption Value Calculation Based on S&P 500 Option Formula

Additional Assumptions

Risk-Free Rate: 2.23%
Term (years): 2 years remaining
Strike Price: 100% Recovery

Recovery % on Senior Debt	Volatility 12.0%	Volatility 15.0%	Volatility 18.0%
90.00	3.84	5.32	6.83
80.00	1.11	2.06	3.15
70.00	0.18	0.54	1.10
60.00	0.01	0.08	0.25
50.00	0.00	0.00	0.03

Redemption Option Value as a % of Reorganization Value

Notes

- The above option pricing uses Black-Scholes to determine value based on assumptions noted.
- Midpoint volatility assumption of 15% is based on 60D historical volatility for S&P 500 from July 2010 to present.
- Risk-Free Rate is based on US Treasury (2 Year) average yield from July 2000 to present.

- *Bottom-line implications of the redemption option value rule:* Where the senior class's distributions on the plan confirmation or sale order date are close to the full principal amount of their claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)), the immediately junior class is likely to be entitled to some redemption option value. On the other hand, where the senior class is deeply impaired and its distributions on the plan confirmation or sale order date are low in comparison to the full amount of the senior class's claims, the immediately junior class is likely to be entitled to receive little or nothing. Likewise, the time remaining on the redemption period (*i.e.*, three years from the petition date) could affect the redemption option value, with a longer period working in favor of some redemption option value (but not necessarily in all cases, as again the initial percentage recovery for the senior class greatly influences the calculation). Volatility and the risk-free rate can also impact the calculation, but likely less so than the other two factors in the redemption option value context. Moreover, as indicated in the principles, the class entitled to receive the redemption option value generally will be the class immediately junior to the fulcrum security class, assuming that the fulcrum security class is the principal beneficiary of the residual value of the firm under the plan.

- *Note:* Redemption option value only exists if the senior class would receive the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option (*i.e.*, the redemption price). If any redemption option value exists under the foregoing calculation as of the plan effective date or section 363x sale order date, it could be paid pursuant to the plan or section 363x sale order in the form of cash, debt, stock, warrants, or other consideration, provided that any non-cash consideration would be valued on a basis consistent with the manner in which reorganization value was determined. The form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value, regardless of whether such senior class has accepted the plan. If no redemption option value exists on that date (or such class is not otherwise entitled to receive any redemption option value under these principles), nothing further is required and no value is distributed to such junior creditors in the case.

As explained above, the Commission recommended the addition of the redemption option value rule to the general priority scheme of the Bankruptcy Code as a minimum entitlement for the immediately junior class based on the reorganization value of the firm as of the plan effective date or section 363x sale order date. The Commissioners believed that adding the redemption option value rule would appropriately balance the competing issues at stake in the context of value realization events in a case while respecting the value of the senior creditors' interest in the debtor's property.[796]

As suggested by the principles, the redemption option value rule would apply in both the chapter 11 plan and section 363x sale process.[797] The Commissioners discussed the potential challenges to

796 Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *5 ("Outside of bankruptcy, the secured lender may have considerable difficulty capturing anything above liquidation value. If the bankruptcy process itself allows the recovery of more value, why should all of that bankruptcy-enabled excess go to the secured lender.").

797 For a thoughtful discussion of potential value distortion in chapter 11 sales, see Jacoby & Janger, *supra* note 283, at 894–95 ("This going-concern premium is a product of the federal bankruptcy regime. Sometimes, the going-concern premium can only be obtained by acting quickly. Thus, a Bankruptcy Code created speed premium exists (as part of the going-concern premium) when a quick sale is necessary to preserve value. While both premia are worth preserving, we are concerned that parties not be able to exploit the perceived need for speed to distort the Code's distributional scheme."). In addition, Professor Casey explains such potential value distortion as follows:

> Indeed, a recent study by Kenneth Ayotte and Edward Morrison shows that the outcomes of these sales are distorted by conflict between junior and senior creditors. This conflict stems from the mismatched incentives of the different classes of creditors. On the one hand, senior creditors have an incentive to sell the company in a quick sale even when reorganization has a higher expected return for the estate. Thus, when senior creditors are exercising control — which they do in most cases — the result is an inefficient fire sale of the debtor's assets. On the other hand, junior creditors have an incentive to block the quick sale in favor of a drawn-out reorganization even when the sale has the higher expected return for the estate. Thus, in cases where the junior creditors can obtain some control — usually by prevailing on procedural objections — there may be a distortion in favor of an inefficient and prolonged reorganization.

Casey, *supra* note 785, at 761–62 (citations omitted).

applying the redemption option value rule in a section 363x sale process, particularly where the purchaser is a third party and not the senior class. In those situations, the redemption option value can still be calculated based on the net purchase price and parties can determine what, if anything, must be allocated to the immediately junior class. Some of the Commissioners were concerned, however, about paying the redemption option value when the senior class was not getting the future value of the firm *per se*. Other Commissioners noted that the senior class in these situations typically receives distributions and the benefits of the section 363x sale on a quicker timeline; from that perspective, the decision to sell forecloses the plan of reorganization alternative and the future value distributions that would flow from the reorganization. The Commission agreed that the estate — and not the third party purchaser — should be responsible for paying any redemption option value to the immediately junior class. (Of course, any such value paid from the estate will reduce the value available for the senior class.) They also recognized that excluding section 363x sales to third parties from the redemption option value rule could encourage gamesmanship and alternative deal structures that avoid the rule but effectively transfer the assets or their future value to the senior class. Likewise, excluding all section 363x sales could discourage reorganizations without addressing the important issues surrounding the timing of value realization events and value allocation in chapter 11 cases discussed above.[798]

On balance, the Commission voted to apply the redemption option value rule to plans and all section 363x sales (except in small and medium-sized enterprise cases), recognizing that in both the plan and the sale contexts, this default rule will likely encourage consensual resolutions that benefit all. The Commission also acknowledged that the redemption option value principles set forth in this Report are essentially guidelines for courts and parties to use in developing such value allocation principles for more nuanced and complex capital structures than those vetted by the Commission. The Commission found great potential utility to the redemption value option, and it encourages the restructuring community and commentators to build upon this concept to more completely develop fair allocation rules in chapter 11 cases.

2. New Value Corollary

Recommended Principles:

- A prepetition interest-holder, including an insider, should be permitted to retain or purchase an interest in the reorganized debtor without violating the absolute priority rule of section 1129(b)(2)(B)(ii) or section 1129(b)(2)(C)(ii) of the Bankruptcy Code, if applicable, provided that such interest-holder contributes new money or money's worth to the debtor's reorganization efforts in an aggregate amount that is reasonably proportionate to the interest retained or purchased and that is subject to a reasonable market test.

798 The Commissioners discussed similar considerations in determining that a secured creditors' section 1111(b) election should not be operative under the redemption option value rule.

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

American Bankruptcy Institute

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]

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").

1001 NBRC Report, *supra* note 37, at 615.

1002 *Id.* at 618–25.

1003 *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).

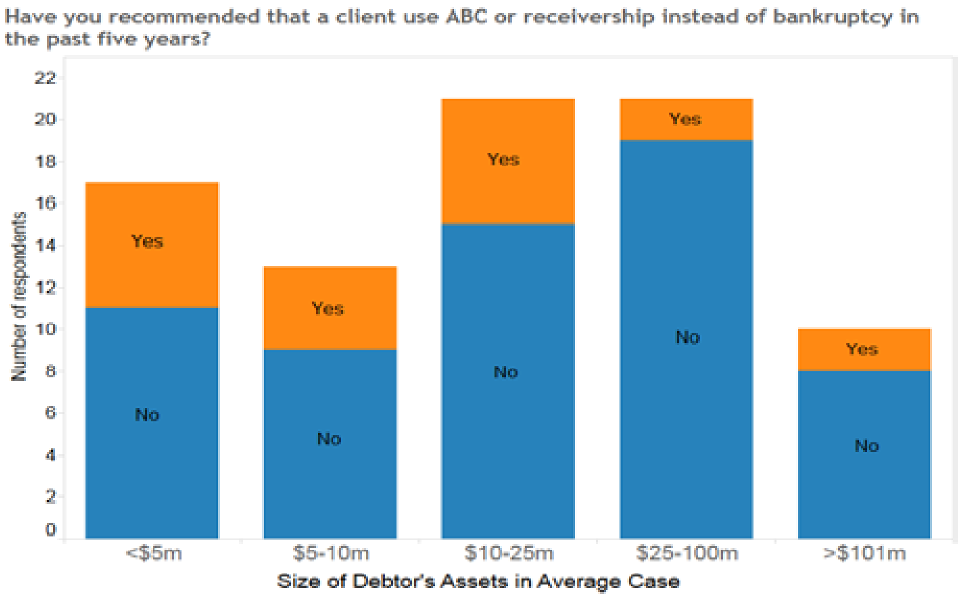
11 U.S.C. § 101(51D). Several commentators have criticized the definition as being too complex and difficult to apply in many cases. *See, e.g.,* Anne Lawton, *An Argument for Simplifying the Codes "Small Business Debtor" Definition*, 21 Am. Bankr. Inst. L. Rev. 55 (2013). For example, the types of assets 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.

1004 NBRC Report, *supra* note 37, at 616.

1005 *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).

1006 *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.

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,

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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 remedy[1015] 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.

1012 Gibbons & 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 1993) (*per curiam*).

1013 Gibbons & 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)).

1014 *See* 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").

1015 *Id.* (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.")).

1016 *Id.* (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)).

1017 *Id.* (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).

1018 *See 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).

1019 *See generally* Geoffrey L. Berman, General Assignments for the Benefit of Creditors (second edition) (2006).

1020 *Id. 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.").

1021 *Compare* 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.

1022 *See* 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.

1023 Business Organizations with Tax Planning § 156.01.

1024 Morrison, *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).

1025 *Id.*

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 Carolina[1026] 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

1026 *See, 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).

1027 *See* Karen M. Gebbia-Pinett, *Small Business Reorganizations and the SABRE Proposals*, 2 Fordham J. Corp. & Fin. L. 253 (2002).

1028 Anne 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).

1029 *See, 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.

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.

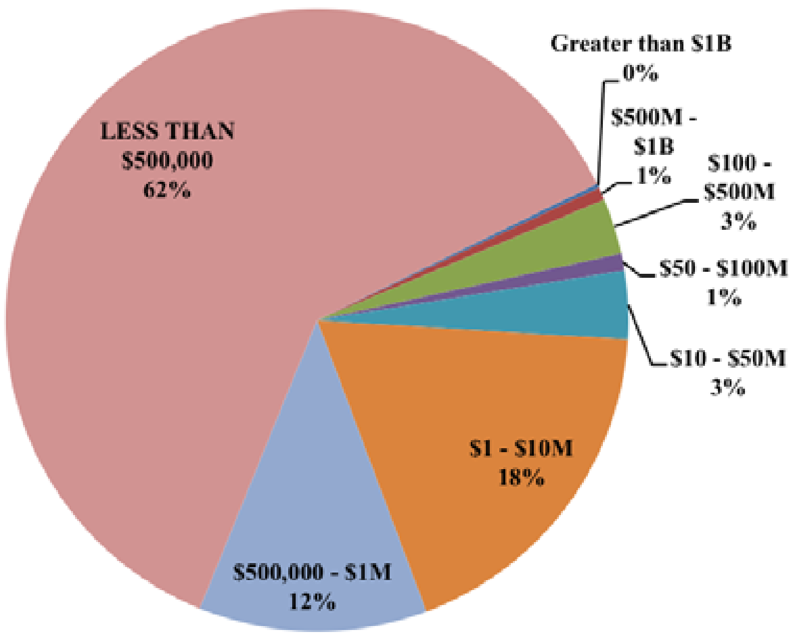
1034 *See, e.g.,* Haines & Hendel, *supra* note 990, at 85 (noting that small business managers are often the owners and discussing how bankruptcy can be a significant distraction); LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 758 (noting that the market for small companies is virtually 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 Etlin: 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

American Bankruptcy Institute

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



Note:
Based on the New Generation data, 74% of companies that filed bankruptcies in 2013 had revenue below $1 million. In addition, based on this same dataset, 90% of the companies that filed bankruptcy in 2013 had 50 or fewer employees.

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 lowe-middle-market companies going through a Chapter 11 process are still having trouble attracting capital. . . ."), *available at* Commission website, *supra* note 55.

1036 Mr. 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.

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

1037 Professor 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.

1038 The 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.

1039 Professor 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).

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.

1040 For 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").

1042 The 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

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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.

1043 Bob 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.

1044 *See, 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

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1045 In 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*.

1046 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).

1047 *See, 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.").

1048 *See* H.R. Rep. No. 109-31, pt. 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89.

1049 *See 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].").

1050 This 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

1051 For a similar proposal that would create a process similar to chapter 12 for small business debtors, *see* Haines & Hendel, *supra* note 990.

1052 *See 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.

1053 *See, 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.").

1054 *See id.*

1055 *See, 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.

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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.

1056 *Oral 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

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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 rule[1067] 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.

1066 Baird & 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.").

1067 The 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.

1068 The 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 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]

1074 For 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*.