What's Wrong with U.S. Chapter 11? A Guide for European Practitioners

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

2. Timing of Section 363x Sales

Recommended Principles:

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

Timing of Section 363x Sales: Background

Section 363 of the Bankruptcy Code currently allows the trustee[314] to sell assets in the ordinary course of business as well as outside the ordinary course of business during the chapter 11 case.[315] A sale outside the ordinary course of business requires, among other things, notice and a hearing. It also typically requires an auction and public sale process.[316] Although courts frequently use the

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

315 11 U.S.C. § 363(b), (c).

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

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

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

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

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

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

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

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

Id. at 1069–70.

318 11 U.S.C. § 1129(a), (b).

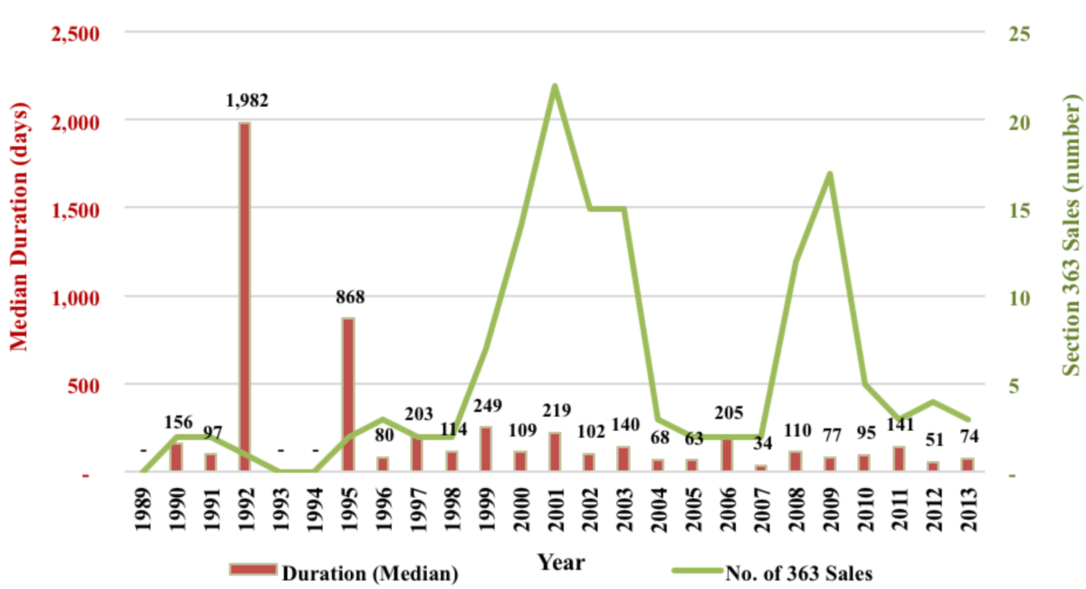
319 *See, e.g., In re* Fisker Auto. Holdings, Inc., 510 B.R. 55, 60–61 (Bankr. D. Del. 2014) ("It is the Court's view that Hybrid's rush to purchase and to persist in such effort is inconsistent with the notions of fairness in the bankruptcy process. The Fisker failure has damaged too many people, companies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

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

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

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

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



Note: In this bar chart above, the y-axis shows the number of days between the petition date and the date of the sale order for a sale of all or substantially all of the debtor's assets. The median number of days between the petition date and the sale order approving a section 363 sale has declined from a high of 1982 days in 1992 to 51 days in 2012. Notably, in some years, the data only show one (*e.g.*, 1992) or just a few orders approving section 363 sales for substantially all of the debtor's assets. (These data may not have captured sales, for example, consummated through a plan of reorganization, which was coded separately in the dataset.) The table below identifies the number of section 363 sale orders per year, as well as the mean and median duration between the petition date and the sale order.

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

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

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

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

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

Timing of Section 363x Sales: Recommendations and Findings

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

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

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

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

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

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

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

D. Payment of Certain Claims upon Filing

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

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

maintenance charges, taxes, and insurance) and determined that the definition of "rent" suggested by the advisory committee — "any recurring monetary obligations of the debtor under the lease" — adequately captured these obligations. The Commissioners also analyzed the varying interpretations and applications of the formula for calculating the cap on rejection damages under section 502(b)(6). The Commission agreed that many courts have confused or misapplied the formula and that, simply stated, the cap should be the rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents. Accordingly, the Commission voted to recommend clarifying the calculation formula.

Finally, the Commission considered the treatment of nontermination damages that a landlord may assert against the estate. These claims typically arise out of the debtor's use or occupancy of the property and are not related to the debtor's rejection of the lease. Notably, section 502(b)(6) applies to, and limits, "the claim of a lessor for damages resulting from the termination of a lease of real property." Accordingly, the Commission agreed that a landlord should be able to file a prepetition claim against the estate, to the extent that the landlord can establish a legal basis and adequate factual support for such claim, for damages not resulting from the rejection of the lease. Such claim would be subject to the claims objection and allowance process under the Bankruptcy Code.

B. Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession's use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.[491] If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.[492] Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.[493]

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor's assets (*i.e.*, a section 363x sale), the court should approve the use, sale, or lease of a debtor's assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is

491 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute "cash collateral," then the debtor must obtain the secured creditor's consent or court approval. *Id.* § 363(c)(2).
492 *Id.* § 363(b).
493 *Id.* § 363(f).

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referred to as an "enhanced" or "intermediate" level of review that considers not only the process adopted by the board of directors (or similar governing body) to approve the transaction but also the reasonableness of the decision itself.

- Only the trustee should be able to propose the use, sale, or lease of a debtor's assets outside the ordinary course of business. Accordingly, no change to existing law is suggested on this point.
- A secured creditor's collateral should not be subject to a mandatory surcharge in favor of the estate but the court should retain the authority to make appropriate allocations of value to the estate as may be warranted under the circumstances pursuant to sections 506(c) and 552(b) of the Bankruptcy Code, as clarified by the related principles. *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.
- For the standard of review governing section 363x sales, see Section VI.B, *Approval of Section 363x Sales*.

General Provisions for Non-Ordinary Course Transactions: Background

In general, section 363(b) of the Bankruptcy Code provides that the debtor in possession,[494] "after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate."[495] The debtor in possession can use, sell, or lease a single asset, multiple assets, a division, or more. A sale of all or substantially all of the debtor's assets is addressed separately in these principles and is subject to a different standard of review and additional procedures.[496]

Under section 363(b), a debtor in possession generally must provide at least 21 days' notice of a motion to approve a proposed use, sale, or lease of property.[497] In general, any party in interest may object to the motion. At the hearing, the debtor in possession bears the burden of proof on the motion and generally must satisfy that burden by a preponderance of the evidence.[498] Courts generally evaluate section 363(b) motions under a business judgment standard. More precisely, courts often state they will approve the motion only if it represents an exercise of the debtor in possession's sound business judgment.[499] But, courts are not always clear or consistent in explaining the factors they consider under this business judgment standard.

494 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model.*
495 *Id.* § 363(b).
496 *See* Section VI.B, *Approval of Section 363x Sales*.
497 Fed. R. Bankr. P. 2002.
498 *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) ("[A] debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business will aid the debtor's reorganization . . . ."); *In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("[T]he proponent of the sale bears the ultimate burden of persuasion . . . ."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) ("[Debtor] clearly bears the burden of demonstrating that a sale of property out of the ordinary course of business under § 363(b) of the [Bankruptcy] Code will aid [debtor's] reorganization and is supported by a good business justification.").
499 *In re* On-Site Sourcing, Inc., 412 B.R. 817, 822 (Bankr. E.D. Va. 2009) ("'A § 363(b) sale is generally viewed as quicker. Only a motion and a hearing are required, and most courts apply a 'business judgment test' to determine whether to approve the sale.'") (quoting *In re* Gulf Coast Oil Corp., 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009)).

General Provisions for Non-Ordinary Course Transactions: Recommendations and Findings

The Commissioners engaged in a detailed review of the various kinds of non-ordinary course transactions pursued by debtors in possession under section 363(b). Debtors in possession have used this provision to enter into long-term equipment lease arrangements or new real property leases that require a substantial outlay of resources; to hire a service provider who is not a professional under section 327; and even to compromise and settle a cause of action.[500] The most common use of section 363(b), however, is to sell the debtor's assets. In each of these instances, the estate is potentially losing something — *i.e.*, cash in the lease, hiring, and settlement scenarios, and assets in the sale context. The Commissioners thus emphasized the important roles of process and review in the approval of these transactions.

The Commissioners examined the various standards of review applicable to similar transactions under state law. In many cases, directors' decisions are protected under state law by the business judgment rule, which presumes that "'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'"[501] Courts have articulated slightly different standards for reviewing proposed transactions under either the business judgment rule or some enhanced form of scrutiny. These variations typically depend on the kind of transaction at issue and the parties involved in the transaction.

For example, some courts undertake a very deferential review of a company's business judgment, focusing largely on the process followed by the board of directors to evaluate and approve the proposed transaction; these courts then defer to the company's articulated business justifications.[502] This type of deferential judicial review often is explained by the notion that business decisions are better made in the boardroom than the courtroom.[503] Other courts scrutinize proposed transactions more closely, reviewing not only the process implemented by the company, but also the reasonableness of the board of directors' business judgment under the circumstances of the case.[504] This latter review often is referred to as an "enhanced" or "intermediate" business judgment standard. In certain

500 *In re* Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (holding that debtor had "sound business reasons for making the sale"); *In re* Cont'l Air Lines, Inc., 780 F.2d 1223, 1226 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 680 (Bankr. S.D.N.Y. 1989) (finding that debtor "articulated sound business reasons for, and is appropriately exercising business judgment with respect to, its decision to sell [certain assets]"); *In re* Baldwin United Corp., 43 B.R. 888, 897 (Bankr. S.D. Ohio 1984) (finding that debtors "met their burden of demonstrating that the disposition will aid their reorganization, and is supported by sound business reasons").

501 *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

502 Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1994); *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

503 *See, e.g.,* Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) (holding that the Court of Chancery correctly deferred to the business decision of the board because "[t]o rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence"). *See also* King v. Terwilliger, 2013 WL 708495, at *7 (S.D. Tex. Feb. 26, 2013) (finding that compensation issues are business questions "far better suited to the boardroom than the courtroom"); *In re* Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) ("[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant. While a court may pass upon the legal effect of a business decision, (for example, whether it violates the antitrust laws), this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance. In short, the decision calls for business not legal judgment.").

504 *In re* Netsmart Techs., Inc. Stockholders Litig., 924 A.2d 171, 192 (Del. Ch. 2007). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("[C]ourt applying [the *Revlon* standard] should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.").

limited circumstances, courts apply heightened scrutiny under which the court exercises its own business judgment and determines if the decision is in the best interests of the company.[505] Finally, if the proposed transaction involves potential self-dealing, conflicts of interests, or insiders, the court may require the company to establish the entire fairness of the transaction.[506]

After much deliberation, the Commission determined that an enhanced business judgment standard was appropriate for evaluating general asset sales and other transactions under section 363(b). The court should approve the sale if it represents a reasonable process and a reasonable exercise of the debtor in possession's business judgment. Moreover, the Commission agreed that only the debtor in possession should be permitted to request the use, sale, or lease of property of the estate, which currently is the structure of section 363.

The Commissioners discussed situations in which the debtor in possession sells assets, and unsecured creditors seek recoveries from that sale, despite the fact that such assets are fully encumbered by a secured creditor's lien. The Commissioners recognized that this situation has occurred more frequently in the most recent economic cycle. Debtors have filed chapter 11 cases with substantially all of their assets fully encumbered by prepetition liens, leaving little value for the debtors' other creditors, at least at the outset of the case. The Commissioners noted that, in some cases, secured lenders will agree to set aside certain amounts for administrative or unsecured claims. The Commissioners, however, did not believe that such surcharges should be mandatory in every section 363 transaction. Rather, parties should remain free to negotiate these types of set-asides based on the facts of any given case. In addition, the Commission reviewed the recommended principles relating to sections 506(c)[507] and 552(b),[508] and found that those sections, together with the new procedures proposed for section 363x sales,[509] sufficiently addressed the underlying concerns.

505 *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (indicating that judicial business judgment may be warranted in derivative litigation involving a special litigation committee in which demand was excused under applicable state law). *See also, e.g., In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("Where an objection is made, the standard to be applied by the court in approving a disposition of assets is variously stated, but the general thrust is that the proposed sale should be in the best interests of the estate."); *In re* Am. Dev. Corp., 95 B.R. 735, 739 (Bankr. C.D. Cal. 1989) ("The proposed transaction is certainly not in the ordinary course of business and requires [the court's] approval. Debtor has the burden of proof to persuade [the court] that the proposed transaction is appropriate in light of its reorganization effort and should be approved."). Also, some courts have been less deferential with respect to break-up fees. *See, e.g., In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("This court agrees with the position taken in *S.N.A.*, *America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is outside the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, 'the proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.'") (citations omitted); *In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]he Court must take into consideration what is in the best interests of the estate. As stated, the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'") (citing *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983)). *But see* Official Comm. of Subordinated Bondholders v. Integrated Res. (*In re* Integrated Res., Inc.), 147 B.R. 650 (S.D.N.Y. 1992), *appeal dismissed by* 3 F.3d 49 (2d Cir. 1993) (finding that the business judgment rule applied in nonbankruptcy contexts and thus relied upon that standard in the bankruptcy context as well to determine whether the proposed breakup fee at issue was appropriate).

506 Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

507 *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral.*

508 *See* Section VI.C.4, *Section 552(b) and Equities in the Case.*

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

2. Finality of Orders

Recommended Principles:

- The court should not be permitted to reconsider a non-ordinary course transaction after the entry of an order approving the transaction or to reopen an auction unless the court finds extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process) to the auction process that may have had a material effect on the sale results. For purposes of this principle, the potential that a new or continued auction would generate a higher value for the transaction alone does not constitute extraordinary circumstances.

Finality of Orders: Background

In the section 363 sale context, a debtor in possession[510] seeks to obtain the highest and best price for the assets. As explained above, a debtor in possession typically conducts an auction process to facilitate this result.[511] The auction procedures are reviewed and approved by the court and may include a marketing and diligence period and rules governing the auction itself.[512] The auction procedures also may contemplate certain bid protections for any stalking horse bidder.[513] After the auction, the debtor in possession presents the winning bid at the auction to the court for approval under the motion to approve the sale. After the court enters the sale order, parties generally have 14 days to appeal the order or it becomes final.[514] Generally, courts are not permitted to reopen an auction or sale.[515]

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

511 *See* Section IV.C.2, *Timing of Section 363x Sales*.

512 One court concluded that "it was necessary to have in place bidding procedures that would provide a reasonable opportunity for the APA to be tested against the market." *In re* Tex. Rangers Baseball Partners, 431 B.R. 706, 711 (Bankr. N.D. Tex. 2010). *See also In re* Innkeepers USA Trust, 448 B.R. 131, 148 (Bankr. S.D.N.Y. 2011) (explaining that bid procedures provide "the market and the Debtors the certainty and the 'rules' that they need to complete the auction process and move on to plan confirmation").

513 A leading bankruptcy treatise explains the rationale for deciding such bid protections in advance of the auction:

> Frequently, the issue of whether the court should approve buyer protections arises upon a motion to approve bidding procedures. The court is asked to approve, before the fact, procedures the propriety of which may be better determined after the "auction" of the property. For example, the reasonableness of a breakup or topping fee may be more difficult to evaluate in a vacuum before the sale. Whether a particular procedure chilled bidding may not be determinable until after the trustee offers the successful bid to the court for approval. However, the fees are to compensate the bidders for facilitating the auction, for example, by guaranteeing a floor on the bidding. If the court were not to approve the fee until after the auction, the leading bidder would not have the assurance necessary to commit to support the auction. Therefore, authorizing the fee only after the auction would defeat its purpose, and the court should address the issues upon a motion to approve the bid procedures."

3 *Collier on Bankruptcy* ¶ 363.02[7].

514 Bankruptcy Rule 6004(h) provides that "[a]n order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise." Fed. R. Bankr. P. 6004(h).

515 *See* Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010). *See also In re* Gil-Bern Indus., Inc., 526 F.2d 627, 628, 629 (1st Cir. 1975) ("[I]t is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a fairly conducted sale merely because a slightly higher offer has been received after the bidding has closed."); *In re* Bigler, LP, 443 B.R. 101, 112 (Bankr. S.D. Tex. 2010) ("To reopen the bidding process to allow [a losing bidder] to make its late bid would be an abuse of this Court's discretion. Accordingly, this Court will not reopen bidding.").

Several issues can arise during the course of the sale process, including modifications to the auction procedures without notice to or approval by the court, bidders wanting to submit noncompliant bids, and even late bidders who cause the debtor in possession, the unsecured creditors' committee, or other party in interest to question whether the bid selected at the auction really is the best and highest offer for the debtor's assets. In this context, courts have granted motions to reopen an auction if it would likely result in a better offer.[516] Accordingly, courts face challenging issues and competing interests when confronted with requests to reopen the auction process or to reconsider the order approving the sale under section 363 of the Bankruptcy Code.

Finality of Orders: Recommendations and Findings

The closing of an auction and the entry of a sale order are key steps in the sale of the debtor's assets. They allow the debtor in possession to close the sale and move forward in the case and the successful bidder to take possession of the assets. The Commissioners discussed the importance of the value generated by section 363 sales to the estate, and the common desire to want to ensure that the sale process is extracting as much value as possible from the assets. The Commission reviewed examples in which this desire caused the debtor in possession, the unsecured creditors' committee, or a party in interest to second-guess the auction results or the sale order and to seek related relief from the court.

For example, in the *WestPoint Stevens*[517] chapter 11 case, the debtor in possession obtained approval of the court to conduct an auction for substantially all of the debtor's assets.[518] One of the debtor's secured creditors, Aretex LLC, along with its affiliates, emerged as the winning bidder at the auction.[519] The court approved the sale and entered a sale order permitting the consummation of the sale to Aretex for the highest and best bid.[520] But, before the sale closed, certain other lenders moved for a stay of the sale order pending appeal of certain provisions in the sale order related to lien releases, claim satisfaction, and distributions.[521] On appeal, however, the Second Circuit rejected the appeal as statutorily moot under section 363(m).[522]

The Commission also reviewed a contrary example found in the *Foamex* chapter 11 case. In that case, the debtors had selected an all-cash bid that was $5 million lower than the all-cash bid of the stalking horse because the stalking horse had conditioned its bid on the inclusion of a credit bid if the auction continued past the then-present round. The bankruptcy reopened the auction and directed the debtors in possession to accept the stalking horse bid (which included the credit bid), even though the debtors in possession had complied with the court-approved bid procedures in

516 *In re* Foamex Int'l, Inc., No. 09-10560 (KJC) (Bankr. D. Del. May 27, 2009). *See also* Lithograph Legends, LLC v. U.S. Trustee, 2009 WL 1209469, at *3 (D. Minn. Apr. 30, 2009) ("A bankruptcy court may disapprove a proposed sale recommended by a debtor-in-possession 'if it has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable.'") (quoting G-K Dev. Co v. Broadmoor Place Invs., L.P. (*In re* Broadmoor Place Invs., L.P.), 994 F.2d 744, 746 (10th Cir. 1993)).

517 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

518 *Id.* at 35.

519 *Id.* at 36.

520 Contrarian Funds LLC v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 242 (2d Cir. 2010) (noting that bankruptcy court entered order confirming that "the winning bid presented 'the highest and best bid at the Auction'") (citations omitted).

521 Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 37 (S.D.N.Y. 2005), *aff'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

522 Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 247 (2d Cir. 2010).

accepting the previous bid. The court thereafter overruled the objection by the previous winning bidder to the sale.

The Commissioners acknowledged that, in some cases, reopening the auction or reconsidering the sale order may generate additional value for the estate. They also raised concerns, however, that endorsing this type of relief may prevent robust auctions in the first instance because prospective bidders need to understand the rules of the auction and to know that, if they participate according to the rules and win, they will be able to close the sale. This type of certainty and respect for the auction rules and sale order can enhance the auction itself and prevent gamesmanship by prospective bidders.

The Commissioners also noted that courts currently have the ability to reconsider their orders under Rule 60(b) of the Federal Rules of Civil Procedure, which provides that the court may relieve a party from a final order if presented with "newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial" and due to "fraud . . . misrepresentation, or other misconduct of an adverse party." The Commissioners reviewed cases in which courts have reconsidered (or refused to reconsider) sale orders.[523] They acknowledged that a motion to reconsider a section 363 sale order can be clouded by the prospect of more value for the estate. Nevertheless, the Commissioners believed that more value alone as ground for reopening an auction or setting aside a sale order was too low of a barrier, did not comply with Rule 60(b), and would introduce too much uncertainty into the sale process.

Consequently, the Commission voted to recommend codifying the standards governing requests to reopen an auction or to reconsider and set aside a sale order. Specifically, it determined that such relief should be warranted only in instances when the evidence presented at the hearing demonstrates procedural impediments in the auction or sale process or extraordinary circumstances.

3. Transactions Free and Clear of Interests

Recommended Principles:

- In general, the trustee should be able to sell a debtor's assets free and clear of all interests in a debtor's assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution and the guidelines set forth in these principles. In addition, the trustee should be able to sell a debtor's assets free and clear of all claims related to a debtor's assets in the context of a sale of all or substantially all of a debtor's assets under section 363x (or a transaction involving less than substantially all of the debtor's assets if the court determines that the trustee has otherwise complied with the requirements of section 363x).
- A trustee should be able to sell assets free and clear of interests if applicable nonbankruptcy law would permit the owner of such assets to sell them free and clear of such interests. The foreclosure rights of a creditor or other third party

523 For examples of courts considering the finality issue and refusing to reopen auction, see *In re* Bigler, LP, 443 B.R. 101 (Bankr. S.D. Tex. 2010); *In re* Extended Stay Inc., No. 09-13764 (JMP) (Bankr. S.D.N.Y. June 17, 2010) [Docket No. 1102] (transcript of record); *In re* Finlay Enters., Inc., No. 09-14873 (Bankr. S.D.N.Y. Nov. 12, 2009) [Docket No. 378] (transcript of record). *But see* Corporated Assets, Inc. v. Paloian, 368 F.3d 761 (7th Cir. 2004) (auction reopened due to improper procedures).

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should not be determinative in this context. Bankruptcy Code section 363(f)(1) and (5) should be amended accordingly.

- A trustee should be able to sell assets free and clear of interests without the consent of any lienholder and regardless of whether the assets generate value in excess of the aggregate value of the liens in the assets, provided that the liens attach to the proceeds of the sale or the lienholder receives another appropriate form of adequate protection of the lien. Section 363(f)(3) should be amended accordingly.
- In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.
- The court should not approve a sale of a debtor's assets free and clear of the following kinds of interests: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to "run with the land" under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to "run with the land" under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing, or disputed ownership interests, except to the extent specified in section 363(h) or (i).
- The sale of a debtor's assets free and clear of executory contracts and unexpired leases should be governed by section 365 or, for collective bargaining agreements, section 1113. Accordingly, the trustee should be permitted to sell the debtor's assets free and clear of executory contracts and unexpired leases only to the extent such contracts and leases are rejected in accordance with section 365 or section 1113, as applicable, and the trustee is permitted by section 365 to recover the property free and clear of the nondebtor counterparty's rights to use or possess such property.
- The court's approval of a sale free and clear of interests or claims under section 363(f) should continue to be considered part of the court's approval of the overall transaction under section 363(b) or (c). Accordingly, no change to existing law is suggested on this point.
- To the extent permitted by these principles for other claims, the trustee should be able to sell a debtor's assets free and clear of any monetary claims by the federal government or a state government against the debtor or the estate, provided that such monetary claims constitute "claims" under section 101(5) under current law. The trustee should not be able to sell a debtor's assets free and clear of any enforcement rights of such government to the extent that such rights are within such government's police or regulatory powers and could be enforced against the debtor or the estate under section 362(b)(4), or to the extent that the state or federal government incurs costs post-sale in the exercise of its police or regulatory powers.

Transactions Free and Clear of Interests: Background

In many chapter 11 cases, some or all of the debtor's property is encumbered or subject to the liens, interests, and claims of various stakeholders. The holders of these liens, interests, and claims may have rights under nonbankruptcy law or prepetition agreements that make the transfer of the debtor's assets difficult or less attractive to prospective lessees and purchasers. These liens, interests, and claims may include mortgages, security interests, easements, or successor liability claims.

Under section 363(f), a debtor in possession[524] may sell its assets under section 363(b) or (c) "free and clear of any interest in such property of an entity other than the estate" only if: (1) "applicable nonbankruptcy law permits sale of such property free and clear of such interest"; (2) "such entity consents"; (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property"; (4) "such interest is in *bona fide* dispute"; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[525] Section 363(f) is limited to "any interest in such property." Notably, this language is different from that used in section 1141(c), which speaks to "property dealt with by the plan [being] free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."[526]

The legislative history of section 363(f) provides little guidance on the scope of the term "interest," other than to acknowledge that a lien should be considered an interest in property.[527] Courts interpreting this section have taken two general approaches: the first construes section 363(f) narrowly and limits its application to liens, security interests, mortgages, and money judgments;[528] and the second takes a more expansive view of interests and captures claims against the debtor or estate property, including successor liability claims, discrimination claims, personal injury claims, and other "claims" within the meaning of section 101(5) of the Bankruptcy Code.[529] Some courts and commentators argue that the expansive approach is necessary to facilitate sales under section 363(f) and to achieve the underlying policy objectives of the Bankruptcy Code.[530]

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

525 11 U.S.C. § 363(f).

526 *Id.* § 1141(c).

527 The legislative history provides, in relevant part:

> At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale, and if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.

H.R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6302; S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5842.

528 *See, e.g., In re* White Motor Credit Corp., 75 B.R. 944, 948 (Bankr. N.D. 1987); *In re* New England Fish Co., 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

529 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 283, 289 (3d Cir. 2003) ("[T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property'") (citing 3 Collier on Bankruptcy ¶ 363.06[1]); *In re* WBQ P'ship, 189 B.R. 97, 105, (Bankr. E.D. Va. 1995).

530 *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 282, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of section 363(f) to include claims); Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252 (3d Cir. 2000) (holding that pursuant to section 363(f), the debtors' contractual payment rights was free and clear of a contractor's previously unexercised setoff rights, but was not free and clear of the contractor's recoupment rights because by their very nature, recoupment rights simply cannot be considered an "interest" in property extinguished by a section 363(f) free-and-clear sale"); *In re* Tougher Indus., Inc., 2013 WL 1276501, at *6 (Bankr. N.D.N.Y. Mar. 27, 2013).

Courts also take different approaches to whether a debtor in possession has satisfied one of the grounds set forth in section 363(f) to support a sale free and clear of interests in the property.[531] For example, some courts require the sale price to exceed the face value of secured claims asserted against the property to satisfy section 363(f)(3).[532] Other courts require only that the sale price exceed the economic value of the creditors' allowed secured claims under section 506.[533] Courts also disagree as to what constitutes a *bona fide* dispute for purposes of section 363(f)(4).[534] They also have taken different approaches to whether the language in section 363(f)(5) providing that the "entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest" includes a cramdown of a chapter 11 plan under section 1129(b).[535]

Transactions Free and Clear of Interests: Recommendations and Findings

The Commissioners analyzed section 363(f) of the Bankruptcy Code and the concept of sales "free and clear" of liens, interests, and claims. They reviewed the original focus of that section on "interests" in estate assets, and they discussed the expansion of that concept to claims of various kinds. The Commissioners identified different kinds of claims that courts have included within section 363(f), including litigation claims, discrimination claims, and successor liability claims. The Commission agreed that this expansive approach to section 363(f) fostered more competition for the debtors' assets and likely enhanced the value of the assets sold through the section 363(f) sale process. The Commissioners questioned whether the historical nexus between "free and clear" sales under section 363(f) and *in rem* notions of property interests still served bankruptcy policy.

To analyze this question, the Commission considered the language and purpose of section 1141(c) of the Bankruptcy Code and the inclusion of claims in the discharge injunction in connection with a chapter 11 plan. The Commissioners suggested that this difference may relate to the more significant notice and due process provided to creditors in the plan process. Although creditors holding general unsecured claims (including the kinds of litigation and other claims mentioned above) do not have any particular interest in the debtor's property, they receive notice and an opportunity to object to the treatment of their claims under the plan. In the section 363 context, such creditors may or may not receive notice of the sale motion or an opportunity to object.

531 *See generally* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002).

532 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008). *See also* Criimi Mae Servs., Ltd. P'ship v. WDH Howell, LLC (*In re* WDH Howell, LLC), 298 B.R. 527, 534 (D.N.J. 2003). *See also* Robert M. Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, Bankr. L. Letter, Oct. 2008, at 7 ("Although the result in *Clear Channel* will be controversial, its specific holding on section 363(f)(3) should not be. Its reasoning is compelling on the statutory language, and it reaches a result well within the mainstream of other court decisions. To sell free and clear under section 363(f)(3), the sales price must exceed the total value of all liens regardless of whether those are totally secured or undersecured.") (citations omitted).

533 *See, e.g.,* WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (*In re* WBQ P'ship), 189 B.R. 97, 105–06 (Bankr. E.D. Va. 1995); *In re* Beker Indus. Corp., 63 B.R. 474, 475–76 (Bankr. S.D.N.Y. 1986).

534 *See, e.g.,* Union Planters Bank v. Burns (*In re* Gaylord Grain LLC), 306 B.R. 624 (B.A.P. 8th Cir. 2004).

535 *See, e.g.,* Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008). *See also* Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, *supra* note 532, at 8 ("Instead of the Chapter 11 cramdown, a state foreclosure proceeding would seem to be a proceeding where the second lienholder could be compelled to accept a monetary satisfaction of its lien and thus satisfy the requirements of (f)(5). Indeed, the word 'foreclosure' means exactly that — the foreclosure of junior interests. A hypothetical state foreclosure proceeding seems so obvious that one wonders why the BAP [in *Clear Channel*] did not simply take judicial notice of it to hold that (f)(5) was satisfied. Perhaps the court's concern was the lack of a solid record on how the foreclosure sale process would play out and specifically what value the property would bring at a foreclosure sale, although the bidding at the bankruptcy court would again seem to be an obvious place to look for the value of the property. The concern about the lack of a record perhaps can be seen in the BAP's references to 363 sales being used to bypass the more procedurally robust confirmation requirements of section 1129 that could protect third-party rights.") (citations omitted).

The Commissioners evaluated whether this difference in process should preclude an expansive reading of section 363(f) that would include liens, interests, and claims. With respect to single-asset sales or smaller transactions, the Commission agreed that the notice currently required by the Bankruptcy Rules was likely sufficient, as assets remained in the estate to potentially fund claims through a chapter 11 plan. In a sale of all or substantially all of a debtor's assets, however, the calculus may be different. On that point, the Commissioners noted that these principles recommend notice and due process procedures similar to what creditors are entitled to in the plan context. Accordingly, under the principles applicable to section 363x sales, creditors holding the kinds of claims subject to section 363(f) under the expansive view would receive notice and an opportunity to object to the proposed sale.

The Commissioners were also persuaded that permitting the debtor in possession to transfer clean title to a purchaser under section 363(f) held potentially significant value for the estate. To that end, the Commissioners analyzed the conflicting interpretations of certain subsections of section 363(f) and identified approaches that would foster a competitive sale process while still protecting creditors' rights against the estate. The Commission agreed that the scope of section 363(f)(1) and (5) should be clarified to focus on the property owner's rights under applicable nonbankruptcy law. The Commission also determined, however, that these ambiguities and perceived barriers to free and clear transfers in a chapter 11 case would likely be mitigated by its recommended change to section 363(f)(3). With the additional notice and process being recommended in the context of sales of all or substantially all of the debtor's assets, the Commission determined that adopting an expansive view of section 363(f) was warranted and adequately protected the interests of stakeholders.

The Commissioners further considered whether any particular liens, interests, or claims should be excluded from section 363(f) under this expansive approach. They methodically evaluated different kinds of claims and interests. They decided that the debtor in possession should be able to transfer property free and clear of all liens, interests, and claims, including without limitation: civil rights liabilities; successor liability in tort; and successor liability in contract. The Commissioners also concluded that the debtor in possession should *not* be able to transfer property free and clear of the following: easements, covenants, use restrictions, usufructs, or equitable servitudes that run with the land; environmental liabilities and related social policies that run with the land; successorship liability under federal labor laws; and partial, competing or disputed ownership interests, except to the extent specified in section 363(h) or (i). Moreover, the Commissioners recognized that a debtor in possession should not be able to sell or transfer assets under section 363(f) in a manner that violates or impedes the police or regulatory power of the federal government or a state government to the extent that such government could enforce those rights against the debtor in possession or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code. The Commission thus recommended that section 363(f) recognize the government's police and regulatory powers to the extent such powers would be enforceable under section 362(b)(4).

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4. Credit Bidding

Recommended Principles:

- In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

Credit Bidding: Background

A creditor with a perfected lien in the debtor's property has certain rights and remedies against the debtor and property within the creditor's collateral package. Among other things, the secured creditor can credit bid the amount of its allowed claim in any sale of its collateral. A secured creditor's right to credit bid exists under both state law and section 363(k) of the Bankruptcy Code. Section 363(k) provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."[536]

A credit bid allows the secured creditor to purchase the property constituting its collateral if other bidders are not willing to pay sufficient value or the creditor prefers to possess the collateral in lieu of payment. The secured creditor also does not need to pay any cash for the property at the sale to the extent the allowed amount of its claim is sufficient to cover the price of its winning bid. Rather, the secured creditor can set off its secured claim against the debtor or the property against the purchase price it otherwise would be required to pay the estate.[537]

Although credit bidding is an integral part of the secured creditors' rights package, it is not without limit. Specifically, section 363(k) allows the court to limit a secured creditor's credit bid for cause.[538] Courts typically have found cause to limit a credit bid if the amount of the secured creditor's claim is disputed or unliquidated.[539] Courts also have found cause to limit a credit bid, however, based on the conduct of the secured creditor. For example, *In re Free Lance-Star Publishing Co.*, the court held that the secured creditor did not have the right to credit bid on assets that did not secure its allowed claim and found cause to limit the creditor's right to credit bid at the auction based on, among other things, the creditor's "overly zealous loan-to-own strategy," in which the creditor acquired the loan

536 11 U.S.C. § 363(k).

537 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (providing historical overview and describing the evolution of credit bidding in bankruptcy), *available at* Commission website, *supra* note 55.

538 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

539 *See, e.g., In re* RML Dev., Inc., 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (valid claims objection that could not be resolved without delaying auction was cause to limit amount of credit bid).

for the sole purpose of obtaining the right to credit bid at an expedited sale of the debtor's assets and discouraged any competitive bidding.[540] Similarly, in *Fisker Automotive Holdings*, the court found cause to limit the secured creditor's ability to credit bid the entire amount of its secured claim because the amount was uncertain, and allowing the creditor to credit bid its entire claim would freeze out all competitive bidding by attractive and capable bidders.[541]

Credit Bidding: Recommendations and Findings

The Commission considered credit bidding under section 363(k) in light of recent case law developments and an arguably expanded application of the cause standard for limiting credit bids. The Commissioners discussed the fundamental role of credit bidding under state law and section 363(k).[542] They also acknowledged that all credit bidding chills an auction process to some extent. Accordingly, the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).

The Commissioners noted that, in some cases, it may be difficult to discern any chilling effect caused by the credit bid itself from a chilling effect resulting from the conduct of the secured creditor seeking to exercise its right to credit bid. For example, the Commissioners discussed situations in which the secured creditor demands a relatively short period to market the property and conduct the sale, requires the marketing materials to highlight the secured creditor's right to credit bid, or takes other actions to discourage a competitive bidding process. The Commission agreed that such conduct could, in fact, depress the value of the property and preclude the estate from receiving any return from the sale.[543] The Commissioners, however, did not want to endorse a principle that would suggest that the chilling effect of a credit bid warrants restrictions on the right to credit bid.[544] The Commission ultimately agreed to maintain the current standard under section 363(k), with the recommendation that the chilling effect of a credit bid not be deemed sufficient cause to limit a credit bid, but that courts should attempt to mitigate any chilling effect through the auction and sale procedures approved in the case.

540 *In re* Free Lance-Star Publ'g Co. of Fredericksburg, Va., 512 B.R. 798 (Bankr. E.D. Va. 20141), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

541 *In re* Fisker Auto. Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

542 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 3 ("For secured creditors, operating on the assumption that in a free-and-clear sale of its collateral the sale price itself establishes the value of the collateral, credit bidding serves two protective functions — both as an undervaluation protection and a proceeds protection. Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the undersecured creditor the full value of the proceeds generated by sale (*i.e.*, the value) of its collateral."); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, Bankr. L. Letter, July 2012, at 8 ("[T]the legislative record indicates that the Code drafters also considered the credit bidding rights separately codified in § 363(k) to be an integral component of adequately protecting the secured creditor's lien rights."). "By holding that a dissenting secured creditor must be afforded credit-bidding rights under § 363(k) in any free-and-clear sale of its collateral under a plan of reorganization, RadLAX ensures that secured creditors have the same credit-bidding rights in plan sales that they have in § 363 sales." *Id.*

543 *See, e.g.,* Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 4 ("When the undersecured creditor's collateral is the entirety of the debtor's assets, therefore, credit-bidding rights in any going-concern sale of the debtor's business and assets give that senior secured creditor the leverage to always insist upon capturing all of the debtor's reorganization surplus, to the detriment of unsecured creditors and other junior classes.").

544 *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) ("To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any deep-pocketed bidder, and no auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."), *available at* Commission website, *supra* note 55.

B. Approval of Section 363x Sales

Recommended Principles:

- The court should approve a sale of all or substantially all of a debtor's assets only if the court finds by a preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements:
    - The sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(1).)
    - The proponent of the sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(2).)
    - The sale has been proposed in good faith and not by any means forbidden by law. (Comparable plan provision found at 11 U.S.C. § 1129(a)(3).)
    - Any payment made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in or in connection with the case, or in connection with the sale and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable. (Comparable plan provision found at 11 U.S.C. § 1129(a)(4).)
    - Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the trustee proposes to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of a kind specified in section 507(a)(2) or (3) incurred through the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(9)(A).)
    - All fees payable under section 1930 of title 28 of the U.S. Code, as determined by the court at the hearing on the sale, have been paid or the trustee provides for the payment of all such fees on the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(12).)
    - The trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection for the purchaser in the order approving the sale.

- A section 363x sale is subject to the principles on orders resolving chapter 11 cases. *See* Section VI.G, *Orders Resolving Chapter 11 Case (Exit Orders).*

- These principles refer to "a sale of all or substantially all of a debtor's assets" as a "***section 363x sale***." For the timing of section 363x sales, see Section IV.C.2, *Timing of Section 363x Sales*.

- The other recommended principles relating to transactions outside the ordinary course also apply in the section 363x sale context. *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*.

Approval of Section 363x Sales: Background

As explained above, a debtor in possession[742] may seek to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code.[743] This kind of sale (referred to in these principles as a "section 363x sale") is a value realization event in the chapter 11 case, as it involves monetizing nearly all of the assets available to satisfy claims against and interests in the estate. Because a section 363x sale terminates the estate's and, in turn, creditors' interests in the assets, the process to facilitate such a sale is critically important to the recoveries ultimately received by creditors. The timing of a section 363 sale can significantly impact value and raises notice and due process concerns; timing issues are addressed separately above.[744]

A section 363x sale transforms the estate from illiquid assets with fluctuating value to a fixed sum of money or securities.[745] Consequently, it potentially alters the value of the estate in a positive or negative direction, depending on factors such as the timing of the sale, the marketing of the assets, the competitive nature of the auction, and the sale and restructuring alternatives explored by the debtor in possession leading up to the section 363x sale. Anecdotal evidence suggests that section 363x sales can facilitate quicker sales that create value for the estate.[746] Such evidence also suggests, however, that a bidder may pursue certain strategies such as a "loan-to-own" strategy or streamlined sale process that may chill bidding and depress the value of the assets.[747]

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

743 *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*. *See also* George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 Hous. L. Rev. 1265, 1267–68 (2004) (discussing increasing use of chapter 11 to sell assets).

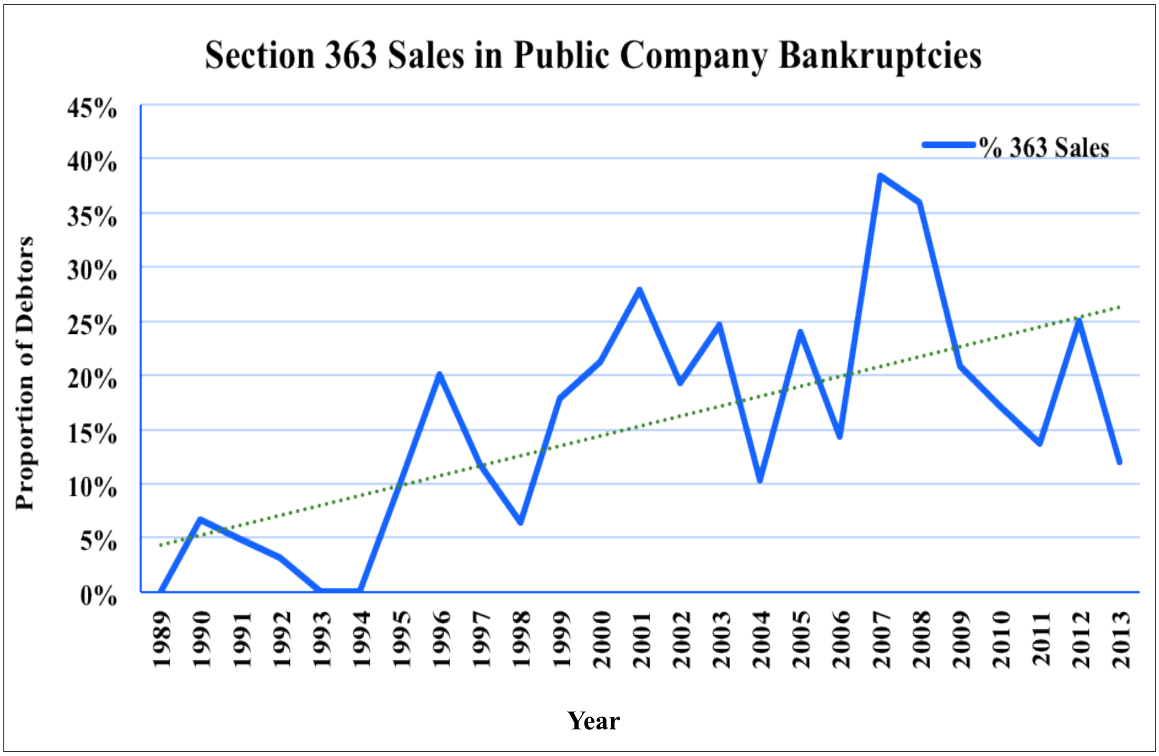
744 *See* Section IV.C.2, *Timing of Section 363x Sales*.

745 *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (describing the potential negative consequences to creditors and, in turn, problems with sales of substantially all of a debtor's assets under section 363), *available at* Commission website, *supra* note 55.

746 For a thorough discussion of the competing perspectives on section 363 sales of all or substantially all of a debtor's assets in chapter 11, see *In re* Gulf Coast Oil Corp., 404 B.R. 407, 419 (Bankr. S.D. Tex. 2009) (reviewing the relevant case law, treatises, and academic literature). *See also* Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012) ("Increasingly, distressed companies have also taken advantage of Chapter 11 as a more efficient way to sell assets."); Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales). *See generally* Section IV.C.2, *Timing of Section 363x Sales*.

747 *See, e.g.,* Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives*, 16 Am. Bankr. L. Rev. 69 (2008) (reporting results of empirical survey on, among other issues, investors' loan-to-own strategies in bankruptcy). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). *See also* Jonathan M. Landers, *Reflections on Loan-to-Own Trends,* Am. Bankr. Inst. J., Oct. 2007, at 44–46 (explaining loan-to-own transactions); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 513 (2009) (discussing, among other things, impact of creditor control on the decision to sell assets in bankruptcy); Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115 ("Controlling secured lenders often use chapter 11 as a vehicle to foreclose on their assets. Traditional corporate reorganizations are becoming a *rara avis*; the strongly emerging norm is for debtors to be liquidated in speedy '§ 363 sales,' the reference being to the Bankruptcy Code section authorizing sales. This practice has become so prevalent that a coauthor and I have spoken of the 'new 'Chapter 3' reorganization.'"); Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, *supra* note 542, at 10 ("The 'loan to own' phenomenon has caused some to question the advisability of credit bidding. The basic concern seems to be that a 'loan to own' lender's primary incentive is, unlike a traditional lender, acquiring the debtor's assets as cheaply as possible, rather than maximizing the recovery on its secured loan. A traditional lender has every incentive to maximize the sale price of its collateral through vigorous competitive bidding, sincerely hoping that bid prices will exceed the amount it could credit bid with its existing secured loan, as this would mean a full recovery on that loan. A 'loan to own' lender, though, has every incentive to inhibit competitive bidding in order to ensure that bid prices will not exceed the amount it can credit bid with its existing secured loan, as this would mean that the 'loan to own' lender can acquire the debtor's assets solely through a credit bid of its existing secured loan and with no additional investment."); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 846 (2004) ("In both judicial and private auction sales, there are often strict requirements for a bidder other than the secured party. In particular, the bidder may have to bring sufficient cash to cover its bid or to provide cash payment very shortly after the bidding. For this and other reasons, it is often the case that few other bidders appear at foreclosure and repossession sales. This fact combines with the bidding-in rules to make it possible for secured parties to buy at their own sales at a price well below market value while avoiding sanctions for violating Article 9's notice and sale procedures.").

The limited empirical data on section 363x sales are mixed in results and difficult to interpret because the coding of the debtor's exit strategy as a liquidation, going concern sale (*i.e.*, section 363x sale), or confirmed plan often is very subjective, and the data are "noisy" in this respect.[748] It also is challenging for empiricists to collect and code creditors' recoveries, particularly in cases that do not have publicly traded securities. In fact, much of the data on chapter 11 cases speak only to the large chapter 11 cases.[749] For example, the chart shown below demonstrates a positive linear trend (illustrated by the dotted line) in the number of section 363 sales in chapter 11 cases, but it also is limited to large public companies.[750]



748 *See, e.g.,* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (study analyzing large public company bankruptcy cases and finding that recoveries in reorganization cases are more than double recoveries from going concern sales); James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691 (2007) (critiquing the LoPucki & Doherty study and finding no statistical difference between sale prices and reorganization prices); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 Mich. L. Rev. 721 (2008) (responding to the White study). *See also, e.g.,* Jenkins & Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization*, *supra* note 42 (developing model to assess efficient and inefficient liquidations in bankruptcy and concluding that about 8 percent of firms are inefficiently liquidated — *i.e.,* they were liquidated when it would have been more efficient to reorganize); Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. Fin. Intermediation, 240–262 (1998) (providing "empirical evidence that takeovers can facilitate the efficient redeployment of assets of bankruptcy firms"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

749 For example, many chapter 11 empirical studies use the UCLA-LoPucki Bankruptcy Research Database or a similarly restricted database. The UCLA-LoPucki Bankruptcy Research Database includes all bankruptcy cases filed between 1980 and 2012 by or against a business debtor or group of affiliated debtors that had assets worth $100 million or more, measured in 1980 dollars.

750 Mr. Shrestha prepared this chart for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The chart analyzes all Section 363 Sales in the UCLA-LoPucki Bankruptcy Research Database (including confirmed, pending, converted, and dismissed cases). Because certain of the cases included in this analysis did not include data for the date of the sale order, some of these data are not included in the chart describing the median duration between the petition date and sale order date in bankruptcy cases. *See* Section IV.C.2, *Timing of Section 363x Sales*. *But see* Jay Lawrence Westbrook, *The Role of Secured Credit in Chapter 11 Cases: An Empirical Review*, 2015 Ill. L. Rev.__, at *6 (forthcoming 2015) (finding, in an empirical study of 424 cases covering a broad cross section of chapter 11 debtors in nine districts, that only about 25 percent of cases and any sales out of the ordinary course, suggesting that section 363 sales are less common that previously thought) (draft on file with Commission). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

Moreover, chapter 11 cases — unlike consumer bankruptcy cases — often present unique facts and involve dynamics not reflected on the court docket. Accordingly, although the data are extremely informative, they should be read with caution, and any claims of causality should be critically analyzed given the foregoing factors and related research limitations (*e.g.*, endogeneity bias, sample selection bias) that may impact research issues in this area.[751]

As suggested above, a section 363x basically determines the maximum recovery any particular creditor will receive in the case. In a case where the debtor's assets are sold for less than the value of the secured claims asserted against the estate, junior creditors — including those holding prepetition unsecured claims and, potentially, postpetition administrative claims relating to the administration of the case following the sale — may not receive any distributions. Although a debtor that liquidates in chapter 11 does not receive a discharge, for all practical purposes, a section 363x essentially discharges the primary source of recovery in business cases (*i.e.*, the debtor's assets).

Accordingly, many courts raise concerns regarding section 363x sales in chapter 11 cases. Among other things, courts and commentators note that these sales skirt the notice and due process protections of the plan process, are often pursued before parties in interest have adequate information to assess the sale and a debtor's restructuring alternatives, and may determine ultimate distributions to creditors without creditors having a vote or the protections of the "fair and equitable" standard of section 1129(b).[752] Nevertheless, as many of these courts recognize, a debtor in possession may have no viable restructuring alternatives, and the section 363x sale may in fact represent its best opportunity for providing recoveries to at least some stakeholders. In these circumstances, many courts strive to make a going concern sale work under the current Bankruptcy Code, but it was not an intended, and thus is not a perfect, fit.[753]

Approval of Section 363x Sales: Recommendations and Findings

Some commentators argue that a sale of all or substantially all of a debtor's assets is akin to a traditional reorganization in that it is a change-of-control event that facilitates distributions of value to creditors and frequently continues the business of the debtor in some form. The Commissioners debated this general proposition at length. Although the Commissioners held differing views on what qualifies as "reorganization" under chapter 11, many of the Commissioners believed that sales of all or substantially all of a debtor's assets have become part of the restructuring landscape. As such, the Commission agreed that the most constructive approach to the issue was to analyze critically the sale process, recognizing the potential utility of the process in achieving certain policy goals, including maximizing value for creditors and preserving jobs for at least part of the debtor's workforce.

751 *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

752 *See, e.g., In re* Gen. Motors Corp., 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[A] debtor cannot enter into a transaction that 'would amount to a *sub rosa* plan of reorganization' or an attempt to circumvent the chapter 11 requirements for confirmation of a plan of reorganization."). *But see* Comm. of Equity Sec. Holders v. Lionel Corp.(*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for.").

753 *See, e.g., In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010) ("A debtor may sell substantially all of its assets as a going concern and later submit a plan of liquidation providing for the distribution of the proceeds of the sale. This strategy is employed, for example, when there is a need to preserve the going concern value because revenues are not sufficient to support the continued operation of the business and there are no viable sources for financing.").

As discussed above, a key concern among the Commissioners was the timing of section 363x sales, which they believed should be conducted in a methodical manner and on a reasonable timeline so that the debtor can identify, and creditors can confirm, that the sale not only provides the best and highest offer for the assets, but also the best restructuring alternative for the debtor and all of its stakeholders. The Commission recommended a 60-day moratorium on section 363x sales to promote these objectives.[754]

The Commissioners reflected on the meaningful differences between a section 363x sale process and the chapter 11 plan process. They considered both substantive and procedural aspects of the process. For example, courts use slightly different standards of review in approving sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code.[755] Most courts employ some form of heightened scrutiny, but that review may simply turn on whether the debtor in possession has a "good reason" for the proposed sale under the circumstances of the particular case.[756] Such a standard is a much different and arguably lower standard than that applied to confirmation of a chapter 11 plan in the cramdown context.[757] The Commissioners observed that a cramdown analysis generally is applicable because most classes of creditors will be impaired by the sale and receive nominal, if any, distributions from the sale proceeds. Moreover, creditors do not get a "vote" on the sale. To confirm a plan under the section 1129 cramdown standard, a debtor must establish that the plan (i) satisfies

754 *See* Section IV.C.2, *Timing of Section 363x Sales*.

755 *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1072 (2d Cir. 1983) (reviewing historical standard applicable to bankruptcy sales and finding more flexibility under section 363(b), noting that "[i]n fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike"). *See also In re* Whitehall Jewelers Holdings, Inc., 2008 WL 2951974, at *6 (Bankr. D. Del. July 28, 2008) ("[W]hen a preconfirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization'") (citation omitted); *In re* George Walsh Chevrolet, Inc., 118 B.R. 99, 101 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re* Indus. Valley Refrigeration & Air Conditioning Supplies, Inc., 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (holding that a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a preconfirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business — including provision of proper notice, adequacy of price, and 'good faith' — is heightened").

756 *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). *See also In re* Boston Generating, LLC, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010) ("[A] court rendering a section 363(b) determination must 'expressly find from the evidence presented . . . a good business reason to grant such application.'") (citations omitted); *In re* Daufuskie Island Props., LLC, 431 B.R. 626, 637 (Bankr. D.S.C. 2010) ("(Because the sale is one of substantially all assets of the Estate prior to confirmation of a Chapter 11 plan in this case, authorization for the sale under § 363(b)(1) requires that the Trustee satisfy the 'sound business purpose' test for pre-confirmation sales."); *In re* Gen. Motors Corp., 407 B.R. 463, 489 (Bankr. S.D.N.Y. 2009), *aff'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[I]t is plain that in the Second Circuit, as elsewhere, even the entirety of a debtor's business may be sold without waiting for confirmation when there is a good business reason for doing so."); *In re* Nicole Energy Servs., Inc., 385 B.R. 201, 10 (Bankr. S.D. Ohio 2008) ("[T]he Court may approve a sale of all of a debtor's assets under § 363(b) 'when a sound business purpose dictates such action.'").

757 *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 16–17 (Nov. 15, 2012) ("Chapter 11 plans of liquidation continue to grow in popularity as a 'reorganization' option but offer less protection to creditors, including secured creditors, than a liquidation under Chapter 7. In almost all cases, once the Chapter 11 plan of liquidation has been confirmed, it is the debtor or liquidating trustee who conducts the liquidation without further input from creditors and often with limited (if any) judicial oversight. As a result, creditors have little or no input into the liquidation decisions made by the liquidating trustee/debtor beyond the information contained in the disclosure statement, and there is no real ability on the part of creditors to oversee the liquidation that is being accomplished — allegedly for their benefit. . . . It is becoming commonplace that courts will not condone a §363 sale which disposes of substantially all of the estate's assets without the court and the creditors being advised as to the terms of 'wind-down' or a plan of liquidation. Similarly, many courts allow for what are referred to as "structured dismissals" in lieu of either a Chapter 11 plan of liquidation or a conversion to Chapter 7, without any specific statutory underpinning. Without giving any real guidance as to when a Chapter 11 liquidation is appropriate and the level of interaction available to creditors if the Debtor has not complied with the plan or refuses to cooperate, the secured lender is left only with the option of reclaiming its collateral."), *available at* Commission website, *supra* note 55; *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (suggesting higher standard of review for sales under section 363(b) and (f)), *available at* Commission website, *supra* note 55.

all of the requirements of section 1129(a) (including good faith, the best interests of creditors test, and payment of all administrative claims and certain priority claims), except section 1129(a)(8); and (ii) does not discriminate unfairly and is fair and equitable with respect to each dissenting impaired class under section 1129(b).[758]

In general, a plan discriminates unfairly against an impaired dissenting class if it provides greater value to a class of claims or interests with equal priority. "In a nutshell, if the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class."[759] Section 1129(b)(2) sets forth certain standards that must be met for the plan to be considered fair and equitable as to dissenting impaired classes of secured and unsecured claims and equity interests. The legislative history, however, also makes clear that certain factors that are relevant to the fair and equitable determination are not specified in section 1129.[760] The most common factor considered in this context is a prohibition on a senior class receiving more than 100 percent of its claim in a cramdown scenario.

In addition to substantive distinctions, the Commissioners observed that, particularly in an expedited sale process, many creditors do not receive notice of the sale or sufficient information to evaluate the sale. Yet the sale may eviscerate any recoveries for unsecured creditors in the case, and could subject some or all of the creditors to third-party releases or discharges that impact the parties and property potentially available to satisfy their claims. The Commissioners believed that more meaningful notice to a broader audience is necessary and appropriate in many cases.

Overall, the Commissioners found little difference in the consequences to creditors' rights and claims under an order approving a section 363x sale or an order confirming a chapter 11 plan. They did find, however, significant differences in the creditor protections available under the two processes. Considering the potentially greater exposure to loss of value in the sale context where the assets are being removed from the estate, the Commission ultimately determined that creditors should be afforded at least the same level of protection in the section 363x sale process and in the chapter 11 plan process. The proposed procedural principles for section 363x incorporate these recommendations.

758 11 U.S.C. § 1129(a), (b).
759 Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L. J. 133, 142 (1979).
760 *Id.*

4. Settlements and Compromises in Plan

Recommended Principles:

- In confirming a chapter 11 plan under section 1129 of the Bankruptcy Code, the court should evaluate any settlements and compromises incorporated into the plan under the standard proposed for codification in these principles and grant or deny approval of any such settlements and compromises in the confirmation order under section 1129. This requirement should include any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. Accordingly, section 1129(a) should be amended to add a new provision that requires the court to find, based on evidence presented by the debtor or plan proponent at the hearing, that each settlement or compromise incorporated into the plan is reasonable and in the best interests of the estate.
- For the recommended principles on codifying the review standard, see Section V.G, *Standard for Reviewing Settlements and Compromises*.

Settlements and Compromises in Plan: Background

A chapter 11 plan in many respects embodies a series of compromises between the debtor and its creditors to resolve the debtor's financial distress and allow the debtor to emerge from bankruptcy. Indeed, the heart of the plan is typically the proposed treatment of creditors' claims, which often compromises creditors' rights, and creditors accept or reject this proposed compromise by voting on the plan. A chapter 11 plan can also, however, include more substantive settlements or compromises that do not necessarily relate to the claims allowance process, but do have a material role to play in the debtor's emergence from chapter 11. Outside the plan process, these kinds of settlements and compromises would require separate notice and approval by the court, under Bankruptcy Rule 9019, which these principles propose be codified with certain modifications.[958]

Courts employ different approaches to reviewing settlements and compromises incorporated into a chapter 11 plan. Some courts evaluate the settlement or compromise as part of the plan confirmation process under section 1129, without necessarily requiring separate evidence to support the appropriateness of the agreement. These courts in some respects treat creditors' votes on the plan as sufficient for approving or scrutinizing the terms of settlements contained in the plan, including those not involving claims-resolution matters. Other courts require separate motions under Bankruptcy Rule 9019, or at least separate evidence on the proposed settlement in connection with the confirmation hearing. These courts often distinguish settlements involving claims or causes of action held by the estate from those concerning claims against the estate and wrapped up in the claims allowance process. They generally will require some separate consideration of the former, but handle the latter under the section 1129(a) factors.

958 *See* Section V.G, *Standard for Reviewing Settlements and Compromises.*

Settlements and Compromises in Plan: Recommendations and Findings

Settlements and compromises in chapter 11 cases may affect a debtor's chapter 11 plan indirectly or directly. A settlement proposed prior to the filing of a chapter 11 plan might indirectly affect the plan by dictating the flow of funds for creditors' recoveries under the plan.[959] Parties may challenge these kinds of preplan settlements as inappropriate *sub rosa* plans — *i.e.*, disguised plans that are not being subjected to the scrutiny of the plan confirmation process under section 1129.[960] A settlement also may directly affect a chapter 11 plan if it is incorporated into the plan or is a prerequisite to the plan.

The Commission analyzed the interplay between settlements and plans. The Commissioners discussed the facts of the *Iridium* decision and preplan settlements as potential workarounds of the absolute priority rule of section 1129(b).[961] They observed that these issues are largely mitigated if the settlement is considered in connection with plan confirmation, but they realized that this process forces the issue of whether settlements require separate approval. Some of the Commissioners asserted that the vote on the plan should be sufficient, but others argued that the minority should not be bound by unfavorable compromises. The Commissioners also noted that plan settlements often are not linked to class treatment, so that creditors may not appreciate the terms or import of the settlement in casting their votes.

The Commissioners wrestled with how to identify settlements and compromises that should be subject to separate approval from those integrated into the claims allowance process and addressed by creditors' votes and related provisions in section 1129. The Commission generally agreed that the court should separately approve any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. After weighing the advantages and disadvantages of various approaches, the Commission recommended requiring separate consideration of all settlements and compromises included in, or proposed in connection with, a chapter 11 plan under the "reasonable and in the best interests of the estate" standard recommended for settlements and compromises outside of the plan process under these principles. Notably, the Commissioners did not vote to require a separate motion or hearing on plan-related settlements and compromises. Rather, the Commission agreed that section 1129(a) should be amended to require that the court specifically find that all settlements and compromises included in, or related to, the plan are "reasonable and in the best interests of the estate" as part of the confirmation process.

959 *See, e.g.,* United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir 1984), *cert. denied*, 469 U.S. 880 (1984) ("[A] bankruptcy court abuses its discretion in approving a [preplan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors"). *Cf.* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007) (rejecting *AWECO* test as "too rigid" and not "accommodate[ing] the dynamic status of some preplan bankruptcy settlements"); *In re World Health Alternatives, Inc.*, 344 B.R. 291, 298 (Bankr. D. Del. 2006) (holding that absolute priority rule is not relevant to approval of preplan settlements).

960 *See* Craig A. Sloane, *The* Sub Rosa *Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37, 51 (1999).

961 Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).

factors that may be relevant to particular debtor and its reorganization efforts. The Commissioners were also mindful, however, of witness testimony suggesting that judges may need assistance with complex or contested valuations. For example, the Honorable James Peck of the U.S. Bankruptcy Court for the Southern District of New York testified as follows:

> An inexperienced judge navigating unfamiliar territory introduces an extra element of risk and uncertainty into what necessarily is an unpredictable process in which the skills and personality of the advocate and witness may be the most important variables. An experienced judge is likely to be more facile in deciding these questions but reliability and predictability remain a problem because the experienced judge will be applying his or her own valuation judgments without being able to confer with someone deeply grounded in the subject. Such a valuation professional would be more skilled than most judges in being able to verify or question the assumptions and adjustments that so often dictate the conclusions reached. Valuation is an art more than a science, and it would be helpful for the Court to have access to a seasoned art critic in deciding whether a particular challenged valuation is genuine or a fake.[693]

The Commission reviewed witness testimony and related anecdotal evidence on valuation. The Commission agreed that courts should be permitted and encouraged to appoint valuation experts in cases in which such an expert can provide assistance to the court. The Commissioners debated whether an appointed expert should be permitted to consult with, and to advise the court, but not necessarily be called to testify in the case. After debating the benefits to the court and the due process and procedural concerns for the parties, the Commission agreed that, if the court intends to rely on the court-appointed valuation expert, such expert must testify in the case and be subject to cross-examination. The Commissioners also observed that estate neutrals under the recommended principles could now perform the expanded role, including that of mediator, served by court appointed valuation experts in the past. Finally, the Commissioners evaluated the language of Rule 706 of the Federal Rules of Evidence and found it sufficient as written for the contemplated role of court-appointed valuation experts.

G. Standard for Reviewing Settlements and Compromises

Recommended Principles:

- The principles and standards of Bankruptcy Rule 9019 should be codified to foster uniform application of a court's authority to approve a settlement or compromise of controversies in a chapter 11 case. Accordingly, the court, after notice and a hearing, should approve a trustee's proposed settlement or compromise of a controversy only if the court finds, based on the evidence presented, that the proposed settlement or compromise is reasonable and in the best interests of the estate.

693 *Written Statement of Honorable James M. Peck, VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Feb. 21, 2013), *available at* Commission website, *supra* note 55.

Standard for Reviewing Settlements and Compromises: Background

In general, "compromises are favored in bankruptcy."[694] Negotiated resolutions of disputes can create efficiencies in the process and cost savings for the parties. Bankruptcy Rule 9019, like its predecessor Rule 919 under the Bankruptcy Act, provides a process for parties to request court approval of settlements and compromises. Specifically, Bankruptcy Rule 9109 states, in relevant part: "On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[695] Notably, neither the Bankruptcy Rules nor the Bankruptcy Code provide a standard or criteria for the court to use in assessing proposed settlements and compromises.

Given general bankruptcy policy and the lack of guidance in the Bankruptcy Rules and the Bankruptcy Code, courts tend to invoke a "presumption in favor of settlements," and approve a proposed settlement or compromise unless it "'fall[s] below the lowest point in the range of reasonableness.'"[696] Various courts have developed factors to assist in this determination, but not all courts use the same factors or apply the factors in a uniform manner.[697] This variation can cause uncertainty for the parties filing motions under Bankruptcy Rule 9019 and inconsistent rulings on proposed settlements and compromises. In addition, courts take different approaches to reviewing settlements and compromises incorporated into plans of reorganization.[698] This latter issue is discussed below.[699]

Standard for Reviewing Settlements and Compromises: Recommendations and Findings

A trustee[700] may seek to settle any number of disputes in the chapter 11 case, including claims resolution matters, avoidance claims, and prepetition litigation. Because any such settlement necessarily impacts the estate — either because the estate will fund at least a portion of the settlement or the estate's claims against third parties are being compromised — the court and parties in interest

694 Myers v. Martin (*In re* Martin), 91 F.3d 389, 393 (3d Cir. 1996), quoting 9 Collier on Bankruptcy ¶ 9019.03[1] (15th ed. 1993).

695 Fed. R. Bankr. P. 9019(a).

696 *In re* Tower Auto., Inc., 342 B.R. 158, 164 (Bankr. S.D.N.Y. 2006), *aff'd*, 241 F.R.D. 162 (S.D.N.Y. 2006). *See also* Hicks, Muse & Co., Inc. v. Brandt (*In re* Healthco Int'l, Inc.), 136 F.3d 45, 50 n.5 (1st Cir. 1998) (holding that court may accord deference to the position of the trustee or debtor in possession); *In re* WorldCom, Inc., 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006) ("While the bankruptcy court may consider the objections lodged by parties in interest, such objections are not controlling . . . the bankruptcy court must still make informed and independent judgment."); *In re* Hibbard Brown & Co., Inc., 217 B.R. 41, 46 (Bankr. S.D.N.Y. 1998) (holding that court may exercise its discretion under Bankruptcy Rule 9019 "in light of the general public policy favoring settlements").

697 Courts consider a variety of factors, including:

> (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, with its attendant expense, inconvenience and delay, including the difficulty in collecting on the judgment; (3) the paramount interests of the creditors, including each affected class's relative benefits and the degree to which creditors either do not object to or affirmatively support the proposed settlement; (4) whether other parties in interest support the settlement; (5) the competency and experience of counsel supporting, and the experience and knowledge of the bankruptcy court judge reviewing, the settlement; (6) the nature and breadth of releases to be obtained by officers and directors; and (7) the extent to which the settlement is the product of arm's length bargaining.

In re Iridium Operating LLC, 478 F.3d 452, 462 (2d Cir. 2007) (internal citations omitted). Although several of these factors were developed by courts in the plan settlement context, they also apply outside the plan context in certain instances.

698 A related but different issue arises when the proposed settlement "has the effect of dictating the terms of a prospective chapter 11 plan." *In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 513 (Bankr. D. Del. 2010). In those instances, courts may deny approval of the settlement because it constitutes an impermissible *sub rosa* plan. *See generally*, Craig A. Sloane, *The* Sub Rosa *Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37 (1999).

699 *See* Section VI.F.4, *Settlements and Compromises in Plan*.

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

should have an opportunity to review the terms of the proposed settlement. The settlement or compromise also should be subject to court approval.

The Commissioners discussed the soundness of the notice and hearing process required by Bankruptcy Rule 9019, but acknowledged the discretion given the trustee in presenting the settlement, and the court in approving or denying the settlement. Beyond requiring notice and a hearing, Bankruptcy Rule 9019 establishes no parameters for the content or timing of settlements. It also does not set forth a standard or criteria for the assessment of settlements. The Commission agreed that codifying the settlement approval process, including an appropriate standard of review, would further facilitate the bankruptcy policy of encouraging consensual resolution of disputed matters.

The Commission reviewed the courts' various approaches to assessing proposed settlements and compromises under Bankruptcy Rule 9019. This review identified a wide range of approaches, from "the lowest point of reasonableness" to the "fair and equitable" standard used to evaluate compromises and plans under the Bankruptcy Act. The Commissioners generally agreed that the lowest point of reasonableness standard did not sufficiently scrutinize the terms of the proposed settlement and its impact on the estate. Several Commissioners suggested using the fair and equitable standard as applied by the U.S. Supreme Court in *TMT Trailer Ferry*.[701] Other Commissioners expressed concern regarding the ambiguity surrounding "fair and equitable" and its common association with approval of a chapter 11 plan in the cramdown context.[702] The Commissioners generally agreed that something less than fair and equitable, but still meaningful, should govern the approval of settlements and compromises.

After discussing different approaches, the Commission agreed to use a hybrid standard that requires the settlement or compromise to be "reasonable and in the best interests of the estate." It favored this standard because it would adequately protect the estate and allow the court to weigh the evidence presented on the particular settlement or compromise. Although the Commission believed that the proposed "reasonable and in the best interests of the estate standard" is better suited than a "fair and equitable" standard for the review and approval of settlements and compromises, it also believed that courts should still engage in a totality of the circumstances analysis that considers factors such as those articulated by courts under the fair and equitable approach.[703]

701 Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968).

702 The fair and equitable standard is used in the cramdown context under section 1129 of the Bankruptcy Code. The Bankruptcy Code also incorporates elements necessary to make a plan fair and equitable to any particular class of creditors or equity securities holders that reject the plan.

703 *See, e.g.,* Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968) ("[T]he judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.").

context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles."[967] The Commission determined that a similar provision should govern property dealt with under a plan.

The Commissioners discussed the relevant policy considerations, and they believed that a chapter 11 plan should provide protection from claims as broad as that recommended by the Commission to be available in a section 363x sale. In addition, some Commissioners voiced concerns that treating these two situations differently could encourage a sale of the debtor's assets even when reorganization was feasible or a better alternative for many of the debtor's stakeholders. Although the Commission recommended principles to govern the sale of substantially all of a debtor's assets under section 363x, the Commission agreed that such sales should not provide better or meaningfully different treatment for parties than the plan process. Accordingly, if a debtor in possession[968] could sell assets free and clear of a particular claim under the recommended principles for section 363(f), a debtor or plan proponent also should be able to achieve a similar result under sections 1129 and 1141.

G. Orders Resolving Chapter 11 Case (Exit Orders)

Recommended Principles:

- The Bankruptcy Code should be amended to clarify that a chapter 11 case can be resolved only in the following three ways: (i) confirmation of a plan under section 1129; (ii) conversion of the case under section 1112; and (iii) dismissal of the case subject to section 349.

Orders Resolving Chapter 11 Case (Exit Orders): Background

In general, a debtor exits chapter 11 through a confirmation order, a dismissal order, or a conversion order. Section 1129 governs the entry of an order confirming a chapter 11 plan.[969] Section 1112 generally provides that "on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or to dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause."[970] Section 305 permits a court to dismiss or suspend a case under the Bankruptcy Code if "the interests of creditors and the debtor would be better served by such dismissal or suspension."[971] Moreover, section 349 addresses

967 *See* Section V.B.3, *Transactions Free and Clear of Interests*.
968 As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.
969 11 U.S.C. § 1129.
970 *Id.* § 1112(b).
971 *Id.* § 305(a).

the effect of a dismissal order and provides, among other things, that such an order reinstates certain liens and actions, vacates certain orders, and revests property in its prepetition owner.[972]

The Bankruptcy Code's alternatives for ending a chapter 11 case are fairly straightforward. Nevertheless, courts have been confronting an exit strategy for chapter 11 debtors that does not necessarily fall within the traditional exit alternatives, commonly called a structured dismissal.[973] A "***structured dismissal***" is a hybrid dismissal and confirmation order in that it typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third party-releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case. These additional provisions — often deemed "bells and whistles" — are usually the result of a negotiated and detailed settlement arrangement between the debtor and key stakeholders in the case.

Structured dismissals are subject to some controversy as a result of these bells and whistles. Opponents of structured dismissals argue that the Bankruptcy Code either does not authorize or expressly prohibits some of the provisions included in these dismissal orders.[974] Proponents of structured dismissals, on the other hand, argue that the Bankruptcy Code does authorize the practice and note how practical and efficient structured dismissals can be in certain cases.

Some of the common features present in structured dismissal cases are noted below:

- Substantially all of the debtor's assets have been sold pursuant to a section 363 sale.
- The debtor's estate is essentially reduced to cash to be distributed.
- The secured creditors are undersecured and there are insufficient funds to pay the administrative claims associated with the case (the case is administratively insolvent).
- A detailed settlement agreement (or similar) that disposes of significant issues in the case has been approved by the court and may have been consummated.
- As a result of the settlement agreement (or similar), the proceeds of the sale of the debtor are transferred from the estate to the undersecured lender.
- There is an alternative claims-allowance process.
- There are third-party release provisions.
- A portion of the sale proceeds have been carved out to create a "gift" trust to benefit lower priority creditors, proceeds to which they would likely not be entitled in a chapter 11 plan.

972 *Id.* § 349.
973 Although structured dismissals appear to be increasingly common, some cases suggest that structured dismissals are not a recent development. *See In re* Buffet Partners, L.P., 2014 WL 3735804 (Bankr. N.D. Tex. July 28, 2014) ("On a smaller scale, structured dismissals occur regularly in this and other bankruptcy courts. Often the parties enter the case on the eve of foreclosure, work out their differences through a sale or giveback of property, and the parties enter an agreement submitted to this court for approval that results in the dismissal of the case."); *In re* Aerospace & Indus. Mfg., Inc., 2008 WL 2705071 (Bankr. N.D. Tex. July 7, 2008) (dismissing case pursuant to a settlement agreement because dismissal will result "in a more favorable return to unsecured creditors . . . who otherwise risk receiving nothing in the case").
974 *See* 11 U.S.C. § 349(b).

- The court retains jurisdiction over the case after dismissal and all prior court orders survive the dismissal.

The debate regarding the authority of a court to issue an order approving a structured dismissal is grounded in the Bankruptcy Code. Parties on both sides of the debate agree that (i) the court is authorized to issue a "plain vanilla" case dismissal order for cause when in the best interests of creditors and the estate, and (ii) the Bankruptcy Code is silent regarding what a dismissal order may or may not contain. Proponents of structured dismissals focus on sections 1112(b) and 305(a) of the Bankruptcy Code as grounds for approving such dismissals. Opponents focus on the purpose of section 349[975] and the general principle that section 305(a) is considered an extraordinary remedy because a court's order under that section is not subject to review on appeal.[976] Other Code sections and legislative history also are cited on both sides of the debate.

Orders Resolving Chapter 11 Case (Exit Orders): Recommendations and Findings

Anecdotal evidence suggests that the increasing use of structured dismissals is linked directly to the rise in sales of all or substantially of a debtor's assets under section 363 and outside of the plan process. Parties may request a structured dismissal because of the actual or perceived costs and delays associated with the plan-confirmation process or a conversion to chapter 7 of the Bankruptcy Code. Parties also may resist a conversion because of the automatic appointment of a trustee and the subordination of unpaid administrative claims in the chapter 11 case to the administrative claims incurred by the chapter 7 trustee.

The Commissioners acknowledged that courts are approving structured dismissals to try to facilitate efficient case resolutions. Some of the Commissioners supported the use of structured dismissals when no other alternative is available to monetize the debtor's assets for the benefit of at least some creditors. Other Commissioners observed that there are always alternatives — *e.g.*, a sale followed by a clean section 1112/349 dismissal order, a sale followed by conversion to chapter 7, a sale in chapter 7, a sale after a clean dismissal under state law. These Commissioners noted that a lack of alternatives was not the issue; rather, it really was driven by the desire of the purchaser, debtor, or other key stakeholder to sell the assets free and clear under section 363(b) and (f) of the Bankruptcy Code quickly, plus to get some of the benefits of a confirmation order without complying with the disclosure and soliciting provisions of the confirmation process.

975 *See, e.g.,* H.R. Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6294 ("The basic purpose of [section 349] is to undo the bankruptcy case as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case."). *See also* Armel Laminates, Inc. v. Lomas & Nettleton Co. (*In re* Income Prop. Builders, Inc.), 699 F.2d 963, 965 (9th Cir. 1982) ("11 U.S.C. § 349, treating the effects of a bankruptcy, obviously contemplates that on dismissal a bankrupt is reinvested with the estate, subject to all encumbrances which existed prior to the bankruptcy. After an order of dismissal, the debtor's debts and property are subject to the general laws, unaffected by bankruptcy concepts. After dismissal a debtor may file another petition for bankruptcy unless the initial petition was dismissed with prejudice."); Citizens First Nat'l Bank of Princeton v. Rumbold & Kuhn, Inc. (*In re* Newton), 64 B.R. 790, 793 (Bankr. C.D. Ill. 1986) ("[T]o the extent possible a dismissal of a petition reverses what has transpired during a bankruptcy."); *In re* Safren, 65 B.R. 566, 571 (Bankr. C.D. Cal. 1986) ("The objective of section 349(b) is to restore all property rights, insofar as is practicable, to their positions when the case was filed.").

976 *See, e.g., In re* Monitor Single Lift I Ltd., 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) ("Granting an abstention motion pursuant to § 305(a)(1) requires more than a simple balancing of harm to the debtor and its creditors; rather, the interests of both the debtor and its creditors must be served by granting the requested relief.").

The Commissioners debated the advantages and disadvantages of structured dismissals. The Commissioners generally believed that debtors should be able to sell all or substantially all of their assets under section 363(b) when that is the best and most efficient way to maximize value and potentially rehabilitate the business. They did not, however, endorse a process that short-circuits or completely eliminates creditor protections under the Bankruptcy Code. The Commissioners discussed certain components of structured dismissals that were particularly troubling in this respect, including provisions that violate the absolute priority rule,[977] grant third-party releases,[978] or deviate from the traditional claims-allowance process.[979] As explained by the U.S. Trustee in *LCI Holding Co*.:

> The Motion [requesting approval of a term sheet in aid of consummation of a court-approved sale] attempts to restructure the rights of existing creditors and equity, without affording parties in interest the protections of a plan, disclosure statement and the confirmation solicitation process. . . . Were the Term Sheet presented as a plan, the Court would be required to approve a disclosure statement to be used to solicit votes from the impaired creditor classes. The Term Sheet raises multiple issues that a disclosure statement would address. These issues include claim resolution procedures, resolution of fee claims[, etc.]. . . . A disclosure statement would also have to address facts not disclosed in the Motion, including but not limited to a budget, a liquidation analysis, and the existence of any additional assets.[980]

The Commissioners first considered whether provisions could be drafted that would facilitate some of the objectives of a structured dismissal, but that would not impede the rights of, and key protections for, creditors in the case. As the Commissioners started to carve out problematic provisions from an "acceptable" structured dismissal, they recognized that it likely was an unworkable solution. They bolstered this conclusion by reviewing the recommended principles for section 363x sales. Under these recommended principles, a sale of all or substantially all of a debtor's assets will incorporate appropriate creditor protections from the confirmation process. If these protections are implemented, the court may approve the sale, and its order may include (i) a release or discharge to affect claims protection for the purchaser and (ii) certain specified distributions to priority creditors. The Commissioners believed that the recommended principles for section 363x sales should render the use of structured dismissals unnecessary.

Accordingly, the Commission recommended strict compliance with the Bankruptcy Code in terms of orders ending the chapter 11 case. Specifically, the Commission agreed that a court should be

977 *See, e.g., In re* Jevic Holding Corp., No. 14-01465 (3d Cir. Aug. 14, 2014) [Docket. No. 45] (citing Begier v. I.R.S., 496 U.S. 53, 58 (1990)).

978 *In re* Jevic Transp. Corp., No. 13-00104 (SLR) (D. Del. Jan. 24, 2014) [Docket No. 22]. Indeed, a structured dismissal may provide a broader third-party release than otherwise would be permissible in the chapter 11 case. For example, the release provision in *TLG Liquidation* is particularly notable:

> The Debtors, for themselves and their estates, and the Committee, for itself and its members, representatives, agents, professionals, successor and assigns . . . release and forever discharge any and all Claims and Defenses against the Agent, each of the Lenders and their respective shareholders, partners, members, officers, directors, managing members, employees, representatives, agents, professionals, successors and assigns, from the beginning of time through the date the Approval Order becomes a final and nonappealable order.

In re TLG Liquidation Corp., No. 10-10206 (MFW) (Bankr. D. Del. Apr. 30, 2010) [Docket No. 275].

979 For example, in some cases, claims are allowed in the amounts submitted in the dismissal motion unless there is an objection. *See In re* GI Joe Holding Corp., No. 09-10713 (KG) (Bankr. D. Del. Feb. 23, 2011) [Docket No. 746]; *In re* Wickes Holdings LLC, No. 08-10212 (Bankr. D. Del. May 12, 2009) [Docket No. 1418].

980 *In re* LCI Holding Co., No. 12-13319 (KG) (Bankr. D. Del. May 21, 2013) [Docket No. 773].

permitted to confirm a plan under section 1129, convert a case under section 1112, or dismiss a case provided that the requested dismissal and the dismissal order satisfy the applicable provisions of, and do not permit the parties to work around, the Bankruptcy Code.

Out-of-Court Restructurings – Outline
Damian S. Schaible

- **Balance Sheet Management: Introduction**
  - Depressed prices of bonds and wide open capital markets are leading some companies to consider right sizing balance sheets through exchanges, new debt issuances and buybacks (in particular, seeing this in energy sectors, for instance)
  - Importance of understanding documents to see the art of the possible outside of court
  - Distressed companies may look to extend debt maturity profile, reduce interest expense and obtain flexibility regarding interest payment schedules
- **Debt Instruments and Contractual Limitations**
  - Before a company embarks on a debt restructuring or equity repurchase, careful review of terms of outstanding debt is critical
  - In many situations, covenants in bank or other debt agreements will restrict the company's ability to repurchase or prepay its debt, and/or incur additional debt, or repurchase its equity
  - In most situations, there will be some limited exceptions to these restrictions, and the company will need to ensure that the terms of any proposed restructuring fit within such limited exceptions (or otherwise seek an amendment or refinance such agreement in full)
  - Note that this discussion is focused on non-investment grade companies; investment grade companies will have few, if any, restrictive covenants
  - **Types of debt instruments and typical covenants for each:**

Debt Instrument	Description	Covenants typically applicable to debt restructurings and equity repurchases
Senior credit facility	▪ Generally are guaranteed by company's subsidiaries and secured by first priority liens on substantially all assets	▪ Limits on: ▪ Restricted Payments/ Investments ▪ Other debt prepayment ▪ Debt incurrence/ maintenance

		▪ Lien incurrence/ maintenance ▪ Amendments of other debt ▪ Amendment requirements
Indenture for high yield notes	▪ Straight debt securities issued in registered (public) or 144A/Reg S (private) offerings ▪ Generally are guaranteed by company's subsidiaries ▪ May be secured (often on a second priority basis) or unsecured	▪ Limits on: ▪ Restricted Payments ▪ Debt incurrence ▪ Lien incurrence ▪ Amendment requirements
Indenture for convertible notes	▪ Convertible debt securities issued in registered (public) or 144A/Reg S (private) offerings ▪ Convertible into equity either at the holders' option or contingent upon certain events ▪ Generally not guaranteed and are unsecured	▪ Generally no restrictive covenants ▪ Amendment requirements
Project finance debt facility	▪ Limited or non-recourse debt incurred at subsidiary level to fund development of specific project ▪ Generally only secured by that project's assets	▪ Generally the restrictive covenants in this instrument would not affect activities at parent level

- **Options for Distressed Companies**
    - A distressed company may look to extend its debt maturity profile, reduce interest expense and obtain flexibility regarding interest payment schedules by offering debt investors security or better terms
    - **Amendments to current debt agreements**
        - **Amendments to credit facilities** to extend maturity or modify interest rate. Amendments of this type generally require 100%

consent of lenders. Such amendments/waivers will likely require fees to be paid to lenders, and may be unavailable for distressed companies. Possible that lenders will agree to such amendments in return for collateral (or higher priority collateral), if available to pledge, and/or a reduction in their commitments

- **Amendments to note indentures** generally require 100% consent of noteholders to extend maturity or change interest rate, making them impractical for distressed debt restructuring purposes given large numbers of holders. Such amendments may also "substantially modify" terms of security and therefore SEC rules deem it to be a new security (requiring additional disclosure and burdensome execution process)

- **New debt**

- **Exchange offers and buybacks: Overview** (avoids 100% consent requirement but effective only with respect to debt exchanged)

  - **Exchange offer**: A public offer to holders of its outstanding debt securities, agreeing to exchange newly issued debt or equity securities (or possibly bank loans) for the outstanding debt securities, perhaps with a fair value at a significant discount to the face amount of the old securities

  - **Private note exchange**: Similar to above, but involves a private offer to limited number of holders of outstanding debt securities. Care needs to be taken to avoid characterization as a "tender offer" under U.S. securities laws

  - **Cash redemption**, should the terms of the debt permit optional redemption at the proposed time of the transaction. Redemption may be an unattractive option as the redemption price generally is the face amount or, in many cases, is at a premium to the face amount (which in the current environment may likely significantly exceed the market value)

  - **Cash tender offer**: In a cash tender offer, the company makes a public offer to purchase some or all of its outstanding debt securities, perhaps at a significant discount to the face amount. Often combined with a consent solicitation to obtain exit consents to amend terms of debt securities remaining outstanding

  - **Cash purchases**: The company may be able to acquire its outstanding debt securities through open market purchases or in privately negotiated transactions, often at a significant discount to the face amount. Care needs to be taken to avoid characterization as a "tender offer" under U.S. securities laws. Often impractical to accomplish in connection with a debt refinance, as limited ability to impose timing constraints, new financing often contingent on retiring old debt and New York law suggests exit consents are only valid so long as all holders are given same opportunity to consent (so would require a stand-alone consent solicitation to all holders)

    - **Loan buybacks**: Few senior credit facilities clearly permit non-pro-rata prepayments or buybacks at market prices. Most require pro-rata prepayment (or some type of amendment to permit such non-pro rata prepayment)

    - **Bank debt prepayment/termination**: Bank debt agreements generally permit prepayment of outstanding amounts and/or termination of commitments at any time, although may require a prepayment/termination fee

- **Cash Purchases v. Tender Offers:** what is the difference and how can one avoid purchases being deemed a tender offer?

    - **What is a Tender Offer?** Eight factors have been held to characterize a tender offer and thus are generally considered to be relevant to determining whether purchases of securities constitute a tender offer:

        - (1) active and widespread solicitation of holders;

        - (2) solicitation made for a substantial percentage of the outstanding debt;

        - (3) the offer to purchase is made at a premium over the prevailing market price;

        - (4) the terms of the offer are firm rather than negotiable;

        - (5) the offer is contingent on the tender of a fixed minimum number of securities and is often subject to a fixed maximum as well;

        - (6) the offer is open for only a limited period of time;

        - (7) the offeree is subject to pressure to sell his or her securities; and

        - (8) the public announcement of a purchasing program precedes or accompanies rapid accumulation of the target's securities

    See Wellman v. Dickinson, 475 F. Supp. 783 (S.D.N.Y. 1979)

- Therefore, four <u>key</u> factors to structure non-tender cash purchases:
  - (1) individual negotiation with limited number of people;
  - (2) absence of premium;
  - (3) no deadlines; and
  - (4) no publicity
- 10b-5 liability applies. Execution considerations:
  - Offer to purchase and letter of transmittal required for tender offers
  - Dealer manager of a tender offer likely to require a "14e-1" (compliance as to tender rules) opinion. May also require disclosure opinions for tender offers below par (as heightened liability risk for disclosure)
- Note that as market convention is that loans are not securities, there are no securities law concerns with loan buybacks (although common law fraud applies)

- **What is an Exchange Offer?**
  - An exchange offer is similar to a cash tender offer, but instead of offering cash consideration, offer new securities to existing investors in exchange for existing securities
  - Similar analysis for Private Note Exchanges v. Exchange Offers, as Cash Purchases v. Tender Offers, plus a few additional considerations
  - As transaction involves the issuance of new securities, such securities must either be registered or exempt from SEC rules
    - **Registered exchange**. SEC must review and clear Form S-4 registration statement; no limits on soliciting or offerees. No automatic effective for WKSIs and can't use existing S-3 shelf
    - **Rule 3(a)(9) exempt exchange**. No SEC registration, but can't have dealer solicitation or a

dealer success fee (limited ability to pay financial advisor a fixed fee and conduct certain activities). Must exchange for securities of "same issuer"; can't exchange non-guaranteed sub debt securities for parent debt securities

    - **Section 4(2) exempt exchange**. No SEC registration. Limits on soliciting activities (similar to a typical 144A offering; limit to QIB and AI holders who complete a questionnaire)

- 10b-5 liability applies. Execution considerations:

    - Offering document, including or incorporating information of company and terms of new securities, required

    - Dealer manager of an exchange offer likely to insist upon customary due diligence, comfort letters, reps/warranties in DMA and opinions as is a securities issuance

- **Debt security for loan exchanges?** Offer bondholders ability to exchange notes for a new tranche of loans under a bank facility

    - Potentially utilizing unused credit facility availability (or an accordion feature) or baskets permitting ability to incur additional secured debt

    - Loans are viewed by the market not to be securities, BUT:

        - Limiting distribution of loans is key to this conclusion

        - If loans are securities, limiting distribution is key to ensuring no violation of securities laws

    - Therefore, only QIBs are typically involved in and policies applicable to Section 4(2) exempt exchange offer as set out above are proscribed

    - While consideration being offered is not a security, likely still a "tender offer" and still subject to the tender offer rules above, which may be inconsistent with the bank process

- Strategies for encouraging tenders/exchanges include:
  - Exit consent solicitation
    - Strip out covenants so that holders of old notes are left with less protection and encouraged to tender or exchange for new bonds
    - Key issue is what covenants can be stripped with what level of consent – removal of restrictive covenants usually requires majority consent; removal of guarantors and/or collateral usually requires super-majority (66%/75%/90%) consent, and amendment of payment or maturity terms usually requires 100% consent. Also, if consent solicitation creates a new "security" under SEC rules, SEC registration or an exemption therefrom is required
    - May not work well for partial tenders, as investors will have notes remaining
  - In an exchange offer, separate cash payments or superior terms for new securities
    - E.g., exchange subordinated or unsecured debt with senior or secured debt
  - Adverse impact on liquidity
    - If a tender or exchange is successful, a more limited trading market for the old securities that remain outstanding will adversely impact the trading price for the old securities encouraging holders to accept the offer
- If the security holders view these measures as too aggressive, there is a risk that they will coordinate their actions, which can result in a failed tender offer; the risk of such coordinated action is amplified where the securities are closely held

- **Creative structures** may be necessary in order to structure around existing debt covenants. Examples include:

- **Second lien debt layering**. Remaining Debt and Lien covenant capacity, and/or credit facility refinancing capacity, could be used to incur second lien debt. Proceeds could be used to repay existing credit facility debt (to the extent credit facility amendments may be needed for the transaction) or unsecured debt

- **Drop-down financings**. Using any available Restricted Payment covenant capacity to transfer assets or cash to unrestricted subsidiaries, such unrestricted subsidiaries could incur debt secured by such assets/cash. Proceeds of the new debt could be used to repay unsecured debt, in return for an intercompany loan from the unrestricted subsidiaries to the company which provides interest payment cash flow on the new secured debt (provided such intercompany loan could be incurred as "refinancing debt" upon the unsecured debt being repaid)

- **Unrestricted subsidiary debt capacity**. Credit facilities are often guaranteed by only U.S. subsidiaries. Foreign non-guarantor subsidiaries with their own cash flow could incur secured debt (subject to Debt incurrence/maintenance covenant capacity and/or Restricted Payment capacity through declaring foreign subs unrestricted) and use proceeds to repay unsecured debt

- **Asset Sale covenants**. A company can often sell assets and use the proceeds to pay down secured debt. Should the Asset Sale covenants not require a corresponding permanent retirement of commitments upon such repayment, this could free up secured debt basket capacity to refinance unsecured debt

- **Lien covenant holes**. We have seen that certain indenture covenants have a hole in the Liens covenant that allows unlimited liens securing any credit facilities (rather than the dollar-capped credit facility permitted debt basket, or otherwise capped by a secured leverage ratio). As "credit facility" is often defined broadly, this effectively allows any available permitted debt to be secured, and accordingly can be used to replace unsecured debt with secured debt. In addition, subordinated liens may also be available

- **Production payments (for oil and gas companies)**. Indentures for oil and gas companies often allow unlimited incurrences of production payment obligations (and liens to secure such payments)

- **Prepack stapled exchange offers**. A company's exchange offer solicitation document could simultaneously serve as a chapter 11 disclosure statement and be accompanied by a proposed chapter 11 prepack plan. The combination might be used to threaten to bind holdouts