Rethinking Chapter 11

May 28-29, 2015
House Committee on the Judiciary
Hearing Room 2237
Rayburn House Office Building, 2nd floor
Washington, D.C.

(The front entrance of the Rayburn Building on Independence Ave. or side entrance on South Capitol St. will be most convenient)

This conference, organized by the National Bankruptcy Conference, brings together lawyers, judges, insolvency professionals, and academics under the Chatham House rule to discuss the fundamental challenges facing the law of corporate reorganizations. Particular attention will be paid to proposals from the National Bankruptcy Conference and the ABI Commission on Bankruptcy Reform.

Speakers

Hon. Thomas L. Ambro, Circuit Judge, United States Court of Appeals for the Third Circuit

Douglas G. Baird, University of Chicago Law School

Corinne Ball, Jones Day

Donald S. Bernstein, Davis Polk & Wardwell

Harlan Cherniak, KKR & Co. L.P.

Anthony J. Casey, University of Chicago Law School

Josiah M. Daniel III, Vinson & Elkins

Hon. Robert D. Drain, Bankruptcy Judge, Southern District of New York

Dennis F. Dunne, Milbank, Tweed, Hadley & McCloy

Marcia L. Goldstein, Weil, Gotshal & Manges

Alan W. Kornberg, Paul, Weiss, Rifkind, Wharton & Garrison Richard

Richard Levin, Cravath, Swaine & Moore

Kenneth Liang, Oaktree Capital Management

Thomas Moers Mayer, Kramer Levin Naftalis & Frankel

Todd F. Maynes, Kirkland & Ellis

James E. Millstein, Millstein & Co.

Edward R. Morrison, Columbia Law School

Harold S. Novikoff, Wachtell, Lipton, Rosen & Katz

Isaac M. Pachulski, Pachulski Stang Ziehl & Jones

Hon. Pamela Pepper, District Judge, Eastern District of Wisconsin

Hon. Brendan L. Shannon, Bankruptcy Judge, District of Delaware

Catherine L. Steege, Jenner & Block

Nate Van Duzer, Fidelity Investments

Jane Lee Vris, Millstein & Co.

Hon. Eugene R. Wedoff, Bankruptcy Judge, Northern District of Illinois

Agenda

Thursday, May 28

10:00 - 10:15 *Introduction*.

Richard B. Levin

10:15 - 11:15 *Third-Party Oversight*. Chapter 11 relies upon the debtor in possession to shepherd the reorganization process. Apart from the appointment of an examiner or trustee, the Bankruptcy Code does not contemplate that any other third party will facilitate the process. The panel will discuss the possibility of giving parties the option of putting such a person in place with a role that is tailored to the circumstances of the particular case.

Harold S. Novikoff, Hon. Robert D. Drain, Ken Liang

Break

11:35 - 12:35 *Reorganization Value and Option Value*. Outside of bankruptcy, secured creditors receive only the foreclosure value of their collateral. Moreover, until a foreclosure actually takes place, the junior debt trades for a positive price—even when out of the money, junior debt has option value. Under existing law, secured creditors capture the value of the reorganization, while at the same time junior classes are cut off from the future possibilities of the firm. Whether this is an appropriate way to resolve the tension between junior and senior creditors, or whether instead, junior creditors should be entitled to retain option value when the firm is reorganized, is one of the most strongly debated issues in corporate reorganizations.

Donald S. Bernstein, Anthony J. Casey, James E. Millstein

Lunch

1:30 - 2:30 *Bargaining and Plan Negotiation*. Bargaining is the lifeblood of Chapter 11; the class-by-class plan vote is a key driver of the protection to which dissenters are entitled and the plan confirmation process; and the rules governing classification, voting (including the effect of limitations on voting in intercreditor agreements and RSAs), and the impact of voting on stakeholder entitlements are critical components of the framework within which the bargaining takes place. As the players in bankruptcy have changed over the years, the rules that govern this bargaining and voting process may need to change as well.

Thomas Moers Mayer, Isaac M. Pachulski, Hon. Eugene R. Wedoff

Break

2:50 – 3:50 *Corporate Groups*. Chapter 11 serves to rehabilitate businesses as a whole, but the Bankruptcy Code itself operates on legal entities. In the typical large reorganization, there is a group of related legal entities. Many have their own creditor constituencies, but cannot stand on their own as stand-alone businesses. What is interest of the business as a whole may not be in the interest of creditors of its discrete components, and recognizing rights against specific legal entities may be at odds with rehabilitating the business as a whole. Resolving this tension presents an important challenge for bankruptcy reform.

Marcia L. Goldstein, Todd F. Maynes, Hon. Brendan L. Shannon

Break

4:10 – 5:10 *Bankruptcy and the Trust Indenture Act*. The Trust Indenture Act sharply limits the ability of creditors to act collectively outside of bankruptcy. Some Chapter 11 reorganizations focus exclusively on restructuring debt that cannot be restructured outside of bankruptcy without unanimity. The operations of the business are untouched and the rights of trade and other noninvestment debt are entirely unaffected. Providing a simpler and easy path for such reorganizations in Chapter 11 is another possible avenue of bankruptcy reform.

Harlan Cherniak Dennis F. Dunne, Alan W. Kornberg, Nate Van Duzer, Jane Lee Vris

Reception

6:00 – 7:30

Friday, May 29

9:00 – 10:00 *Small Business Bankruptcies*. The vast majority of Chapter 11s involve small businesses. Often the business itself is hard to separate from the person who owns and operates it. The stakes are so small that there is no active creditors' committee. Unpaid taxes often compose the largest portion of the unsecured debt. These present a special set of challenges for bankruptcy reform.

Edward R. Morrison, Josiah M. Daniel III, Hon. Pamela Pepper, Catherine L. Steege

Break

10:20 – 11:20 *Absolute Priority.* The absolute priority rule remains the central organizing principle of the law of corporate reorganizations. Its exact contours, however, remain unclear. Gifting, cramdown interest rates, new value, and unfair discrimination are concepts that remain in flux. Making sense of these doctrines needs to be part of any comprehensive bankruptcy reform.

Hon. Thomas L. Ambro (moderator), Douglas G. Baird, Corinne Ball

Break

11:40 – 12:40 *Plenary Session*.

Richard B. Levin

National Bankruptcy Conference Rethinking Chapter 11 Conference: Speaker Bios

HON. THOMAS L. AMBRO

EDUCATION

Georgetown University B.A., *magna cum laude*, *Phi Beta Kappa* (1971)
Georgetown University Law Center J.D. (1975)
Admitted to Delaware Bar (1976)

PROFESSIONAL CAREER

Circuit Judge, U.S. Court of Appeals for the Third Circuit (2000-)
Richards, Layton & Finger, P.A. (1976-00)
Judicial Clerkship, Hon. Daniel L. Herrmann, Chief Justice, Delaware Supreme Court (1975-76)

AFFILIATIONS

American Bar Association, Section of Business Law: Chair (2001-02); Chair-Elect (2000-01); Vice-Chair (1999-00); Secretary (1998-99); Editor, *The Business Lawyer* (1999-00); Chair Committee on Legal Opinions (1994-98); Former Co-Chair, Committee on Publications; Committee on Business Bankruptcy
American Law Institute
New York TriBar Opinion Committee Non-voting Member
American College of Commercial Finance Lawyers Charter Member
American Inns of Court Foundation, Board of Trustees

PUBLICATIONS

Author, "Third Party Legal Opinions," Ch. 15A in *Asset Based Financing: A Transactional Guide*, Matthew Bender (1990)
Co-author, "Some Thoughts on the Economics of Legal Opinions," *Colum. Bus. L. Rev.* 307 (1989)
Principal drafter, *Special Report by the TriBar Opinion Committee, "UCC Security Interest Opinions,"* 49 *Bus. Law.* 359 (1993)

PROF. DOUGLAS G. BAIRD

Douglas Baird graduated from Stanford Law School in 1979. At Stanford he was elected to the Order of the Coif and served as the managing editor of the Stanford Law Review. He received his B.A. in English summa cum laude from Yale College in 1975. Before joining the faculty in 1980, he was a law clerk to Judge Shirley M. Hufstedler and Judge Dorothy W. Nelson, both of the U.S. Court of Appeals for the Ninth Circuit.

Mr. Baird served as Dean of the Law School from 1994-1999. His research and teaching interests focus on corporate reorganizations and contracts.

Education: B.A., 1975, Yale College; J.D., 1979, Stanford University.



CORINNE BALL

PARTNER

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EXPERIENCE HIGHLIGHTS

City of Detroit's chapter 9 plan of adjustment confirmed

Oncor Electric Delivery Company shielded from Energy Future Holding's chapter 11 bankruptcy

National Public Finance Guarantee Corporation and MBIA Insurance Corporation prevail on appeal in Harris County bond litigation

HONORS & DISTINCTIONS

2013 Winner — Outstanding Achievements in Restructuring, M&A Advisor

2012 Winner — "Woman of the Year in Restructuring," IWIRC

2011 Human Relations Award, Anti-Defamation League

Repeatedly recognized in:
Chambers Global and *Chambers USA*

K&A Restructuring Register

Legal 500 US

PLC Which lawyer?

Best Lawyers in America (since 1995)

Super Lawyers "Top 50 Women Lawyers in NY" (since 2007)

Lawdragon 500 Leading Lawyers in America

Who's Who Legal

EDUCATION

The George Washington University (J.D. with honors 1978); Williams College (B.A. magna cum laude 1975; Phi Beta Kappa)

BAR ADMISSIONS

Corinne Ball has 30 years of experience in business finance and restructuring, with a focus on complex corporate reorganizations and distressed acquisitions, both court-supervised and extra judicial, including matters involving multijurisdictional and cross-border enterprises. She is co-head of the New York Office's Business Restructuring & Reorganization Practice and leads the Firm's European Distress Investing Initiative.

Corinne led a team of attorneys representing Chrysler LLC in connection with its successful chapter 11 reorganization, which won the *Investment Dealers' Digest* Deal of the Year award for 2009. She also led a team of attorneys in the successful restructuring of Dana Corp., which emerged from bankruptcy in 2008, and has orchestrated many other complex reorganizations involving companies such as Axcelis Technologies, Kaiser Aluminum, Oceans Casino Cruise Lines, Tarragon, and The Williams Communications Companies. In addition, she has counseled lenders and bondholders in the ABFS, Comdisco, Excite@Home, Exide SA, GST Communications, Iridium, Loews, NorthPoint Communications, Telergy, VARIG Airlines, and Worldcom restructurings, among others. Corinne also has advised on loans, acquisitions, and workouts involving professional sports franchises, including the Charlotte Bobcats, the Detroit Redwings, the Minnesota Wild, the New Jersey Devils, and the Phoenix Coyotes.

Corinne leads the Firm's distressed M&A efforts and is the featured "Distress M&A" columnist for the *New York Law Journal*.

Corinne won the Turnaround Management Association's "International Turnaround Company of the Year" Award and was named "Dealmaker of the Year" by *The American Lawyer* and one of "The Decade's Most Influential Lawyers" by *The National Law Journal*. She is a director of the American College of Bankruptcy and the American Bankruptcy Institute.



Donald S. Bernstein is a partner with Davis Polk & Wardwell LLP in New York, where he is Practice Coordinator of the firm's Insolvency and Restructuring Practice Group. Mr. Bernstein's practice includes representing debtors, creditors, liquidators, receivers and acquirers in major corporate restructurings and insolvency proceedings, as well as advising financial institutions regarding resolution planning and the credit risks involved in derivatives, securities transactions, and other domestic and international financial transactions. He is a past chair of the National Bankruptcy Conference, a Commissioner on the ABI Commission to Study the Reform of Chapter 11, a director of the International Insolvency Institute and a past director of the American College of Bankruptcy. He has been Treasurer and a member of the Executive Committee of The Association of the Bar of the City of New York, and is a former Chair of City Bar Association's Committee on Bankruptcy and Corporate Reorganization and of the TriBar Opinion Committee. He is also on the Board of Editors of *Collier on Bankruptcy*. Mr. Bernstein has also served as a member of the Official United States Delegation to the United Nations Commission on International Trade Law. Mr. Bernstein graduated from Princeton University and received his J.D. from the University of Chicago Law School.

Harlan Cherniak

Harlan Cherniak (New York) joined KKR in 2013 as a member of the Special Situations team within KKR Credit. Prior to joining KKR, Mr. Cherniak was a senior investment professional at Venor Capital Management, an event-driven, credit opportunities fund. At Venor, he was actively engaged in the oversight of investments across the capital structure with a focus on the building materials, energy, financials, healthcare, power, and utilities industries. In addition, he served on the informal creditor committees for a number of large U.S. restructurings. Mr. Cherniak previously worked at Longacre, JLL Partners and Credit Suisse. He received a B.S. from The Wharton School at the University of Pennsylvania and currently serves on the board of directors of KKR Energas, Longview Power, Preferred Proppants, and YRF Darca.



Anthony Casey is an assistant professor at the University of Chicago Law School. His research and teaching focus on bankruptcy, finance, and corporate governance. Before becoming a professor, Anthony was a partner at Kirkland & Ellis, LLP in Chicago where he was part of the litigation group. His practice included bankruptcy, securities, and regulatory litigation as well as complex class actions. Before joining Kirkland & Ellis, Anthony had been an associate in the litigation group at Wachtell, Lipton, Rosen & Katz in New York. Anthony also clerked for Judge Joel M. Flaum on the United States Court of Appeals for the Seventh Circuit.

Anthony graduated from the University of Chicago Law School with High Honors in 2002. He was the recipient of the John M. Olin Prize and a member of the Law Review and the Order of the Coif.

Anthony's research has been published in the University of Chicago Law Review, the Columbia Law Review, the Michigan Law Review, the Yale Law Journal, and other major legal journals.

Josiah M. Daniel, III



Biography

Josiah's practice includes representation of debtors, lenders, asset purchasers, noteholders' committees, trustees, and unsecured creditors in corporate and commercial restructurings and in cases under Chapter 11 and all other aspects of bankruptcy and insolvency. Specific experience over more than 35 years of practice includes Chapter 11 debtor representation; Chapter 11 plan negotiation and confirmation; restructuring agreements; loan and lease workouts; Section 363 asset purchases and sales; fraudulent transfer and preference claims; resolution of disputed claims of all types including mass tort claims; postpetition financing arrangements; real estate leases, equipment leases, and executory contracts; pre-bankruptcy planning; and bankruptcy settlements.

Representative Experience

Retail

- Representation of 200-store retail grocery chain as debtor in Chapter 11; confirmed plan of reorganization; disputed claims litigation
- Representation of secured lenders in restaurant companies' and retailers' Chapter 11 cases

Mortgage Lending

- Representation of equity holder and estate-claims defendant in Chapter 11 liquidation of home loan originator and servicer
- Representation of noteholder group in mortgage company Chapter 11; confirmed creditors' plan of liquidation

Oil and Gas; Mining

- Representation of secured equipment lender in Chapter 11 case of oil and gas drilling company; formulated and confirmed creditors' plan of liquidation
- Representation of DIP lender in mining company Chapter 11 case

Chapter 9 - Municipal Debt Adjustment

- Represent hospital district as debtor in Chapter 9 case

Mass Tort

- Representation of parent and affiliates in mass tort Chapter 11 case (consumer lending claims); settlements and plan approved and affirmed on appeal

Real Estate

- Representation of chair of Unsecured Creditors Committee in Hawaiian/Japanese hotel Chapter 11

Telecommunications; Broadcasting

- Representation of ILEC in Chapter 11 cases of CLECs
- Representation of secured lenders in broadcasting restructurings and Chapter 11 cases

Section 363 Purchases and Sales

- Representation of buyers and sellers in Section 363 asset sales in real estate, high tech, manufacturing, distribution, and service sectors

Vinson&Elkins

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Industries/Practices

Energy

Finance

Mass Torts

Restructuring and Reorganization

Technology

Fraudulent Transfer and Other Avoidance Litigation

- Defense of receiver's suit for fraudulent transfer; settled
- Defense of plan trustee's and bankruptcy trustee's fraudulent transfer and preferential transfer litigation

Miscellaneous Claims

- Representation of former director in obtaining allowance in bankruptcy court of indemnification claim

Prior results do not guarantee a similar outcome.

Education and Professional Background

- The University of Texas School of Law, J.D., 1978 (Member, *Texas Law Review*)
- The University of Texas, M.A., 1986
- University of the South, Sewanee, Tennessee, B.A., 1973 (Phi Beta Kappa)
- Partner, Vinson & Elkins LLP, May 1999
- Admitted to practice: Texas, 1978; United States Supreme Court; U.S. Courts of Appeal for the Fourth, Fifth, Seventh, and Tenth Circuits; U.S. District Courts for the Northern, Southern, Eastern, and Western Districts of Texas

Professional Recognition

- *Legal 500 U.S.*, Bankruptcy: Southwest, 2009
- *The Best Lawyers in America*®, Bankruptcy and Creditor Debtor Rights Law, 2005 - 2015; Litigation - Bankruptcy, 2011 - 2015
- *Chambers USA*, Bankruptcy/Restructuring Law, 2006 - 2014
- *Legal Media Group's (Euromoney's) Guide to the World's Leading Insolvency & Restructuring Lawyers*, 2009 - 2010 and 2012
- *Who's Who Legal: Texas*, Insolvency & Restructuring Law, 2007 - 2008
- Selected to the Texas Super Lawyers list, Super Lawyers, 2003 – 2013
- Board Certified in business bankruptcy law by the Texas Board of Legal Specialization since 1988

Activities and Affiliations

- Chair, Planning Committee: University of Texas 33rd Annual Bankruptcy Conference
- Member: Business Law Section, Business Bankruptcy Committee and subcommittees, American Bar Association; Bankruptcy Law Section, State Bar of Texas; Texas Association of Bank Counsel
- Member: American Law Institute

Publications and Presentations

- "Lawyering on Behalf of the Nondebtor Party In Anticipation, and During the Course of an Executory Contract Counterparty's Chapter 11 Bankruptcy Case," 14 *Houston Business & Tax Law Journal* 230, 2014 (Author)
- "Serving Up Chapter 9 Lone Star Style...with a Dash of Detroit," 32nd Annual Jay L. Westbrook Bankruptcy Conference, The University of Texas School of Law, Austin, Texas, November 2013 (Co-author)
- "Trends and Recent Developments in Bankruptcy and Insolvency Law, and Strategies of Interest to Corporate Counsel and Business Attorneys," State Bar of Texas Annual Meeting, June 2013
- "The Landlord's Rejection-Damage Claim Under Bankruptcy Code § 502(b)(6): Lawyering the Allowed Claim Amount with Graphic and Mathematical Expressions," *American Bankruptcy Institute Journal No. 11 at 26*, Dec. 2012/Jan. 2013 (Author)
- "How to Take an Appeal From a Bankruptcy Court's Order," 31st Annual Jay L. Westbrook Bankruptcy Conference, The University of Texas School of Law, Austin, Texas, November 2012 (Co-author)
- "*LBJ v. Coke Stevenson*: Case Changed History and Defined 'Lawyering'," *The Texas Lawbook,* July 2012 (Author)
- "Lessons Learned: Valuation and Bankruptcy Cases from the Past Year," at VALCON2012, Las Vegas, Nevada, February 23, 2012
- "Chapter 11: Entering a New Generation," *The Texas Lawbook*, November 29, 2011 (Author)
- "The Fraudulent-Transfer Risk In Asset Acquisitions and Investments With Financially Distressed Parties in

the United States," *4 Law and Financial Markets Review 32*, January 2010 (Author)

- "Arbitration In Bankruptcy Cases Under the Jurisprudence of the Fifth Circuit Court of Appeals and the District and Bankruptcy Courts in Texas," *43 Texas Journal of Business Law 447,* Fall 2009 (Author)
- "The Federal Equity Receiver's Lack of Standing to Pursue the Fraudulent Transfer Cause of Action," forthcoming
- "Recovering on Unsecured Loans in Chapter 13 Cases of Higher Income Borrowers, *63 Consumer Finance Law Quarterly Report 68,* 2009 (Author)
- "Nonresidential Real Property Leases in Bankruptcy," The University of Texas School of Law Bernard O. Dow Leasing Institute, 2009
- "Another View: New Plan to Save U.S. Auto Industry" and "Another View: How to Save General Motors," *The New York Times' DealBook*, March 23 and April 3, 2009 (co-author with Ron Trost)
- "Executory Contracts and Unexpired Leases," State Bar Advanced Business Bankruptcy Course, 2006
- "Single Asset Real Estate Bankruptcy," ABA Business Bankruptcy/Committee Meeting, April 2006
- "Developing, Pleading and Presenting Effective Defenses Using Fed. R. Civ. P. 12(b)," Bankruptcy Litigation - Advanced Pretrial Practice and Procedure Workshop, The University of Texas School of Law, January 2005
- "Can't We All Get Together? Removal, Remand, and Venue Transfer In Mass Tort Cases," ABA Business Bankruptcy Committee meeting, October 2002
- "Non-Personal-Injury Mass Tort Chapter 11," ABA Business Bankruptcy Committee meeting, October 2001
- "Settlements and Releases in Bankruptcy Cases," State Bar of Texas, Advanced Business Bankruptcy Course, Dallas, Texas, May 2000
- "The Oversecured Lender's Entitlement to Postpetition Interest, Fees, Costs, and Charges Pursuant to Section 506(b) of the Bankruptcy Code," *22 Texas Bank Lawyer* No. 2, July 1998 (Author)
- "A Proposed Definition of the Term 'Lawyering,'" *101 Law Library Journal 207*, 2009 (Author)
- "What Can Historians Tell Us About the Credit Crisis and Bankruptcy?: A Bibliography of Histories of Credit and of Bankruptcy in the United States," Dallas Bar Association, Bankruptcy Section, 2009
- "*LBJ v. Coke Stevenson*: Lawyering for Control of the Disputed Texas Democratic Senatorial Primary Election of 1948," *31 The Review of Litigation 1*, 2011 (Author and Recipient, "Outstanding Law Review Article Award," Texas Bar Foundation, 2013)

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Robert D. Drain

CURRENT POSITION

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EDUCATION

Yale University B.A., *cum laude* (1979)
Columbia University School of Law J.D., *Stone Scholar 1981-1984* (1984)

PROFESSIONAL CAREER

U.S. Bankruptcy Judge, U.S. Bankruptcy Court, S.D.N.Y. (2002-)
Partner, Paul, Weiss, Rifkind, Wharton & Garrison (1992-02)
Associate, Milbank, Tweed, Hadley & McCloy (1984-92)
Associate Professor, St. John's Law School

AFFILIATIONS

National Conference of Bankruptcy Judges
American Bankruptcy Institute
International Insolvency Institute

PUBLICATIONS

"A Brief Summary of Chapter 11 of the United States Bankruptcy Code," Understanding the Basics of Bankruptcy & Reorganization 2008 Practicing Law Institute (2008)
"Bankruptcy Law and Risk Considerations," 2 *Settlement Agreements in Commercial Disputes* (*Aspen Law & Business 2007*) 22-1–22-88
"Are Bankruptcy Claims Subject to the Federal Security Laws?" 10 ABI L. Rev. 569 (2002)
Frequent lecturer on bankruptcy and reorganization topics.

Milbank

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Education
New York University School of Law, J.D.
Williams College, B.A.

Admissions
New York
US District Court for the Southern District of New York
US Court of Appeals for the Second Circuit

A distinguished restructuring practitioner, author and speaker, Dennis Dunne is a partner in the New York office of Milbank, Tweed, Hadley & McCloy and a member of the firm's Global Executive Committee. He is a Practice Group Leader of the firm's Financial Restructuring Group.

Primary Focus & Experience

Mr. Dunne has extensive experience in representing debtors and creditors in reorganization cases and out-of-court workouts, acquirors of financially distressed companies, providers of financing, and board of directors of public and private companies. Mr. Dunne plays a leadership role in these matters, frequently as counsel to companies or official and unofficial committees representing key creditor constituencies, such as bondholders, agents for lender syndicates, and large debt or equity holders. He also regularly represents private equity funds, hedge funds and other financial institutions acquiring control positions in financially distressed companies, both in and out of court. In addition, Mr. Dunne assists prospective providers of debtor-in-possession financing in structuring, structures and documents exchange and tender offers, and regularly advises boards of directors of public companies on corporate governance and fiduciary duty

matters in the restructuring context. In all such matters, he draws upon his broad experience across several disciplines to craft practical solutions and build the consensus required to implement those solutions. Mr. Dunne also has unparalleled courtroom experience and clients seek him out for his in-court advocacy skills. His engagements have ranged across a wide array of industries, including automotive, airline, apparel, cable and broadcasting, chemical, construction, gaming, healthcare, housing, infrastructure, manufacturing, pharmaceutical, energy, retail, shipping, telecommunications, and textile.

Featured News:

Partner Dennis Dunne Moderates Panel at 2015 TMA Distressed Investing Conference

Las Vegas, NV
Dennis F. Dunne

News:

Partner Dennis Dunne to Moderate Panel at 17th Annual New York City Bankruptcy Conference
New York, NY

Partner Dennis Dunne to speak at the American Bankruptcy Institute's 33rd Annual Spring Meeting
Washington, DC

Dennis Dunne Panelist at J.P. Morgan Global High Yield & Leveraged Finance Conference
Miami, FL

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Industry Recognition, Accomplishments & Client Testimonials

Mr. Dunne is a Fellow and currently the Second Circuit Regent in the American College of Bankruptcy, and he frequently speaks on restructuring and related topics at conferences around

the country. He is a Fellow in the International Insolvency Institute, and has been elected as Conferee to the National Bankruptcy Conference (NBC). He is a co-author of Collier on Bankruptcy, the preeminent treatise in bankruptcy law, and he recently co-authored a chapter entitled "Evaluating strategic debt buybacks: How to pursue effective de-leveraging strategies" in *Navigating Today's Environment: The Directors' and Officers' Guide to Restructuring*. He is a frequent speaker at conferences sponsored by the American Bankruptcy Institute and the National Conference of Bankruptcy Judges.

Clients have described him as “quite simply a great lawyer - he’s intelligent, practical and a pleasure to work with.” He is “in a word – fabulous.” “His knowledge and insight allow him to control the table.” According to clients, “he is extremely knowledgeable, creative, and responsive,” and “can see around corners and provide great advice” “He is commercially minded and gives the practical business perspective.” (*Chambers*). Clients have also recognized him for his "extensive legal knowledge, and an exceptional ability to recall detail." (*The Legal 500*). He is currently listed in *Chambers Global*, *Chambers USA (Band One)*, *The World’s Leading Lawyers for Business*, *Lawdragon 500*, *The Best Lawyers in America*, *The K&A Register of the Leading Bankruptcy and Financial Restructuring Lawyers and Financial Advisors* and *Turnaround & Workouts Top Restructuring Lawyers* of 2008, 2011 and 2014.

Representative Engagements

Select Company Counsel Representations. Vitro S.A.B. de C.V.; Icicle Seafoods; Virgin America, Inc.; Fruit of the Loom, Ltd.; Intermet Corp., RA Holdings, Inc., Fortress Homes, Inc.; MacGregor Golf Company; Outback Steak House, Inc.; Nuron Biotech, Inc.; Atari Inc.; Dairy Mart Convenience Stores, Inc.; Halite Energy, Inc.; Continental Global; BTI Telecom Inc.; Ashanti Goldfields; AM Cosmetics, Inc.; Diveo Broadband Networks; Industrias Unidas, S.A. de C.V.; HomePlace Stores; Sun TV and Appliances, Inc.

Select Official Creditors’ Committee Representations. Lehman Brothers Holding, Inc.; Eastman Kodak Company; Arcapita Bank; Great Atlantic and Pacific Tea Company, Inc.; Fleming Companies; Winn-Dixie Stores, Inc.; Enron Corp.; Charys Holding Company; VICORP Restaurants, Inc.; RCN Corporation; Rhythms NetConnections Inc.; Pliant Systems, Inc.; Hvide Marine Inc.; TBS International, Limited; ICO Global; World Access, Inc.

Select Lender Representations. New Page Corp.,(counsel to first lien lenders); Cengage Learning,

Inc. (counsel to first lien lenders); Magnetation LLC (counsel to *ad hoc* committee of noteholders and DIP lenders); Texas Competitive Electric Holdings Company LLC (counsel for agent for first lien lenders); Overseas Shipholding Group (counsel to lenders); Carrix, Inc. (counsel to agent for first lien lenders); Bosque Power Company LLC (counsel to first lien lenders); Transeastern LLC (counsel to first lien secured lenders); Journal Register (counsel to agent for secured lenders); HomeBanc Corp., (counsel to secured lenders and DIP lenders); Adelphia Communications Corp. (counsel to agent for secured lenders); Telogy, Inc. (counsel to secured lenders); Petrozuata Corp. (counsel to agent for secured lenders); OCA Inc. (counsel to secured lenders); Communications Corporation of America, Inc. (counsel to secured lenders); Ampex Inc. (counsel to secured lenders); Herbst Gaming Inc. (represent agent to secured lenders); Northwest Airlines Corp. (counsel to *ad hoc* committee of secured noteholders); Cybergenics Corp. (counsel to secured lenders); Polymer Group Inc. (counsel to agent for secured lenders in pre-arranged restructuring); Westlake Chemicals Inc. (counsel to agent for secured lenders); InterGen Corp. (counsel to agents for secured lenders in out-of-court restructuring); New Edge Networks (counsel to secured lenders in out-of-court workout); Anthony Crane (counsel to second lien lenders); Boston Gen Corp. (counsel to second lien lenders).

Select Ad Hoc Unsecured Noteholder Representations. Nortel Networks, Inc.; Tronox, Inc.; GEO Homebuilding; Black Elk Energy LLC; Prisa, SA; American Color Graphics; Newark Group; Advanstar; Foster Wheeler Ltd.; Wolverine Tube Inc.; Calpine Corporation; Eagle Foods; Midway Games; Anvil Holdings, Inc.; Delta Air Lines, Inc.; SuCasita ; aai Pharma Inc.; Applied Extrusion Technologies, Inc.; US Airways; Primus Telecommunications; Mpower Communications; NCS Healthcare; HealthSouth.

Select Acquiror and Other Representations. Jackson Hewitt Corp (counsel to acquiror); Madoff Liquidation (counsel to feeder fund); C&S Wholesale Grocers, Inc. (counsel to acquirer of chapter 11 debtor The Grand Union Company); Waste Systems, Inc. (counsel to acquiror of chapter 11 debtor); Sylvania Lighting, Inc. (counsel to acquirors of chapter 11 debtor); Magellan Healthcare (counsel to standby equity purchaser).

Select International Restructurings. Ambac (counsel in municipal debt restructuring of Puerto Rico); Vitro SAB - Vitro Packaging de Mexico, S.A. de C.V. (counsel to company in cross-border restructuring and in chapter 15 case); IUSA (counsel to company in cross-border restructuring and in chapter 11 cases of subsidiaries); Lehman Brothers Holding, Inc. (counsel to official committee in multi-national bankruptcy); GEO Homebuilding (counsel to ad hoc committee of

Noteholders in Mexican restructuring); Prisa Corp. (counsel to ad hoc committee of noteholders in out-of-court restructuring of Spanish company); SuCasita Corp. (counsel to ad hoc committee of noteholders in out-of-court restructuring of Mexican company); Arcapita Bank (counsel to creditors committee in restructuring of Bahrain private equity firm); Nortel Networks, Inc. (counsel to ad hoc committee of bondholders in U.S., Canadian, and UK bankruptcy proceedings); Fruit of the Loom, Ltd. (counsel to Cayman Islands company in bankruptcy proceedings in the Caymans and U.S.) Sino-Forest Corp. (counsel to foreign representative in chapter 15).

Select Oil & Gas Restructurings. Midstates Petroleum Company, Inc. (counsel to bondholders); Quicksilver Resources Inc. (counsel to second lien debtholders); Endeavour Operating Corp. (counsel to first lien lenders); Southern Pacific Resource Corp. (counsel to second lien lenders); and in connection with the restructuring of Samson Resources Corp.

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Marcia L. Goldstein

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Marcia Goldstein is chair of the Business Finance & Restructuring Department at Weil, Gotshal & Manges and a member of the Firm's Management Committee. She has practiced with the Firm for over thirty-five years in all areas of domestic and international debt restructuring and crisis management. She has been a lecturer at Yale, Columbia, NYU and Cornell Law Schools and is a frequent speaker at restructuring seminars both domestically and internationally.

Ms. Goldstein has served as lead restructuring lawyer in a number of major international and U.S. cases, representing a wide range of interests and parties. Her representations have included the Special Administrators of MF Global UK, lead counsel for General Growth Properties, a publicly traded REIT which was the largest real estate company to seek chapter 11 relief; Extended Stay Hotels, a chain of 680 hotels, which had over $7 billion of CMBS and mezzanine debt; assisting AIG with respect to various aspects of the overall restructuring of the company; and U.S. counsel for Kaupthing Bank, the largest Icelandic bank which was in insolvency proceedings in Iceland and chapter 15 in the U.S. She has also represented Readers Digest Association, Washington Mutual Corp., LandSource, Advanta Corp, BearingPoint and Atkins Nutritionals and led the restructurings of WorldCom, Inc., and Parmalat S.p.A. She represents significant creditor interests in connection with the debt issued by Puerto Rico and its public corporations, and in the chapter 9 cases of Stockton and San Bernadino, California and has represented debtors, bank groups, secured and unsecured creditors, purchasers and other parties in other major debt restructurings and chapter 11 cases, including Kodak, Arcapita, Nortel, Allied/Federated, Regal Cinemas, Inc., Washington Group International, Inc., and United Companies Financial Corp.

Ms. Goldstein was selected by *The National Law Journal* as one its "100 Most Influential Lawyers in America", is the 2012 recipient of *Euromoney Legal Media Group*'s award for America's Women in Business Law and was named among the Top 10 New York *Super Lawyers*. In 2009, 2011 and 2013, Ms. Goldstein was named one of the "50 Most Powerful Women in New York" by *Crain*'s New York Business and in 2008, she was named one of the '50 Women to Watch' by the *Wall Street Journal*. She was named one of the two "Women of the Year in Restructuring" in 2008 by the *International Women's Insolvency & Restructuring Confederation*. She has been recognized as an "Outstanding Bankruptcy Lawyer" seven times by *Turnarounds and Workouts*, and as "Global Insolvency & Restructuring Lawyer of the Year" – seven years running – by *Who's Who Legal* (for the International Bar Association). *The American Lawyer* featured Ms. Goldstein as a "Dealmaker of the Year" in 2004 for leading the successful restructuring of WorldCom and in 2008 for her leadership role in situations at the epicenter of the financial crisis, including chapter 11 counsel for Washington Mutual, restructuring advisor to AIG, and U.S. counsel for Kaupthing Bank. Ms. Goldstein is consistently ranked "Band 1" in Bankruptcy/Restructuring for Chambers Global, as a "Leading" Lawyer for

Practice Areas:

- Business Finance & Restructuring

Sectors:

- Energy
- Financial Services
- Hospitality and Leisure
- Retail & Consumer Products

Admissions:

- New York State
- US Court of Appeals 2nd Cir.
- Southern District New York
- US Court of Appeals 5th Cir.
- US Court of Appeals 7th Cir.
- US Court of Appeals 9th Cir.
- Eastern District New York

Education:

- Cornell University (Bachelor of Arts (B.A.), magna cum laude, 1973)
- Cornell Law School (Juris Doctor (J.D.), cum laude, 1975)

Chambers USA and *IFLR1000*, and has been consistently recognized by *Benchmark Litigation* as a "Litigation Star" since 2013. Most recently, she has been recognized in *Expert Guides'* 2014 "Women in Business Law" for Insolvency and Restructuring.

Ms. Goldstein is a member of the National Bankruptcy Conference, the American College of Bankruptcy and the International Insolvency Institute and has chaired the Business Reorganizations Committee of the Association of the Bar of the City of NY.

Ms. Goldstein is also a co-chair of the UJA's Bankruptcy and Reorganization Committee and serves on the Boards of Her Justice and Boys and Girls Harbor. She is a member of the Cornell Law School Advisory Council, and its Executive Committee and has served as its chair.



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PRACTICES

Bankruptcy & Corporate Reorganization

Chair of the Bankruptcy and Corporate Reorganization Department, Alan Kornberg handles chapter 11 cases, cross-border insolvency matters, out-of-court restructurings, bankruptcy-related acquisitions and insolvency-sensitive transactions and investments.

EXPERIENCE

Alan's recent assignments cover a diverse range of clients and matters, including:

- The **senior secured lenders** to Australian-based **Nine Entertainment Group** in the restructuring of more than AUS $2 billion of debt by means of a scheme of arrangement under which the lenders became the principal equity holders of the reorganized company;
- The **ad hoc committee of first lien debtholders of Texas Competitive Electric Holdings Company**;
- Restaurant franchisor **Quiznos** in its out-of-court restructuring and recapitalization;
- **Houghton Mifflin Harcourt Publishing Company** and its affiliates in their prepackaged chapter 11 cases involving the restructuring of over $3 billion in debt;
- **Silver Point Capital**, as DIP and senior prepetition lender agent, in the Hostess Brands chapter 11 case;
- The **senior lenders** and chapter 11 plan sponsors of **Aliante Casino**;
- **Oaktree Capital** in:
  - the **Excel Maritime** and **TMT Procurement** chapter 11 cases; and
  - as lender and plan sponsor in the chapter 11 case of **Aleris International**;
- The **Unofficial Committee of First Lien Noteholders of Exide Technologies**;

EDUCATION

J.D., New York University School of Law, 1977

A.B., Brandeis University, 1974
magna cum laude

RECOGNITIONS

Chambers USA (2014)

Chambers Global (2015)

The Legal 500 (2014)

The Best Lawyers in America (2015)

IFLR1000 (2014)

"Dealmaker of the Year" (2003) *The American Lawyer*

- The **Unofficial Committee of Bondholders of Charter Communications** in connection with Charter's unprecedented "reinstatement" plan under chapter 11;
- **The Winding-up Board of Glitnir hf** in the former Icelandic bank's chapter 15 case; and
- A State regulatory board in the chapter 11 reorganization of the **New York Racing Association**.

Alan recently co-authored, with fellow Paul, Weiss bankruptcy partner Elizabeth McColm, a chapter of the *International Comparative Legal Guide (ICLG) To Corporate Recovery and Insolvency 2014*. Their chapter addresses the challenges involved when a company in the United States finds itself in financial difficulty and the steps that can be taken to restructure effectively. Alan co-authored a similar contribution to *Restructuring & Insolvency 2014* published by Getting the Deal Through.

In connection with his representation of the **California Public Utilities Commission** in the Pacific Gas & Electric Company chapter 11 case, *The American Lawyer* named Alan one of its Dealmakers of the Year in 2003. He has also been selected as one of the leading lawyers in the area of Bankruptcy/Restructuring by *Chambers USA* for the last seven years, is recognized as a leading lawyer in corporate restructuring by both *The Legal 500* and *IFLR1000*, and was chosen by his peers for *The Best Lawyers in America* in bankruptcy and creditor-rights law. In 2015, Alan was once again ranked Band 1 in *Chambers Global*, which recognizes him as "a statesman of the Bankruptcy Bar whose senior experience shows in the quality of his work," who "is very commercial, sensible and thrives in difficult circumstances." Alan's work on the restructuring of Charter Communications was recognized as "Stand Out" (top tier) by the *Financial Times*' "US Innovative Lawyers 2010."

Alan has served as the Second Circuit Regent of the American College of Bankruptcy and was the Chair of the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York from 2005 to 2008. He frequently mediates bankruptcy-related disputes and lectures on bankruptcy-related topics for local, national and international organizations.

RICHARD LEVIN, Partner

Richard Levin is a member of the firm's Bankruptcy, Workout and Corporate Reorganization Practice. An author of the 1978 US Bankruptcy Code, he is an internationally recognized leader in complex bankruptcy litigation, transactional and special situations. With nearly 40 years in the practice, Mr. Levin has gained a reputation as one of the foremost restructuring, bankruptcy and creditor-debtor rights lawyers.

Known for his deep knowledge and understanding of the bankruptcy law, Mr. Levin assists clients in developing sound strategies and creative solutions for complex multi-party problems. He offers considerable expertise for special situations in restructuring and for handling large-scale trustee and examiner engagements, as well as for representing acquirers in distress M&A situations. He also advises clients with non-financial legal or regulatory challenges to help them avoid litigation. As a former senior executive at a publicly traded company, Mr. Levin operates effectively in the boardroom as well as in the courtroom, providing clients with a big-picture perspective on challenges they face.

Mr. Levin currently serves as chair of the National Bankruptcy Conference and is a Fellow of the American College of Bankruptcy. He was a consultant to the World Bank and the Central Bank of Brazil regarding Brazil's 2005 bankruptcy legislation. Since 2002, he has served as a faculty member at the Federal Judicial Center's Bankruptcy Judge Workshops, and he is a lecturer in law at Harvard Law School. He is a sought-after speaker and author on a wide range of bankruptcy issues.

Mr. Levin has repeatedly been recognized as one of the country's leading practitioners of bankruptcy and creditor-debtor rights law by, among others, *Chambers USA* and *Chambers Global*, *Best Lawyers in America*, and *Benchmark Litigation*.

Awards

- *Benchmark Litigation*
  Bankruptcy Star – National, 2012-2015
  Local Litigation Star: Bankruptcy – New York, 2012-2015
- *Best Lawyers in America*
  Bankruptcy and Creditor-Debtor Rights/Insolvency and Reorganization Law, 2007, 2009-2015
- *Chambers Global*
  Bankruptcy/Restructuring – USA, 2013, 2014
- *Chambers USA*
  Bankruptcy/Restructuring – National, 2012-2014
  Bankruptcy/Restructuring – New York, 2007, 2009-2014
- *IFLR1000: The Guide to the World's Leading Financial Law Firms*
  Capital Markets: Structured Finance – US, 2011
  Restructuring and Insolvency – US, 2013-2015



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PRACTICE GROUPS
Bankruptcy, Workout and Corporate Reorganization
Committee Representations
Restructuring and Distressed M&A

EDUCATION
Yale Law School, J.D., 1975; Editor, *Yale Law Journal*

Massachusetts Institute of Technology, S.B., 1972

BAR ADMISSIONS
California, 1976

District of Columbia, 1976

Massachusetts, 1990

New York, 2006

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- *Emory Bankruptcy Developments Journal*
  Distinguished Service Award for Lifetime Achievement, 2013
- *K&A Restructuring Register*
  America's Top 100, 2002-2007; 2009-2011
- *Lawdragon*
  500 Leading Lawyers in America, 2007-2010
- National Conference of Bankruptcy Judges Endowment for Education
  Excellence in Education Award, 2012
- *The Legal 500 US*
  Corporate Restructuring, 2009-2014
  Municipal Bankruptcy, 2012-2014
- *Super Lawyers*- New York
  Bankruptcy; Business, 2015 (ranked "Number One" practicing lawyer in NY Metro area)
- *Who's Who Legal: The International Who's Who of Business Lawyers*
  Insolvency and Restructuring, 2007, 2009-2013

Education

- Federal Judicial Center
  Faculty, Bankruptcy Judge Workshops, 2002-present
- Harvard Law School
  Lecturer in Law, 2004, 2006

Industry

- American College of Bankruptcy
  Vice President, 2009-2011
  Member, Board of Directors, 2007-2012
  Member, Board of Regents, 2003-2007
- National Bankruptcy Conference
  Chair, 2012- present
  Vice chair, 2004-2012
- World Bank
  Consultant, Brazilian bankruptcy litigation

Speaking Engagements

- "Rethinking Chapter 11," National Bankruptcy Conference, May 28, 2015 to May 29, 2015

Kenneth Liang

Mr. Kenneth Liang is a Managing Director & Head of Restructurings at Oaktree Capital Management LP, a Managing Director at OCM Distressed Debt Group, and a Member at The State Bar of California.

He is on the Board of Directors at Pulse Electronics Corp., Tribune Media Co., and STORE Capital Corp.

He joined Oaktree in 1995.

Mr. Liang was previously employed as a Managing Director by Oaktree Capital Management LLC, Senior Vice President by TCW Asset Management Co., an Associate by Graves & O'Melveny, and Senior Corporate Counsel by Dole Food Co., Inc.

He also served on the board at Aleris Corp., Aleris International, Inc., and Tekni-Plex, Inc.

Mr. Liang holds a B.S. degree in Business Finance and Economics from the University of Southern California and a J.D. from Georgetown University Law Center.

KRAMER LEVIN

KRAMER LEVIN NAFTALIS & FRANKEL LLP



Thomas Moers Mayer

Partner

Co-chair, Corporate Restructuring and Bankruptcy

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New York

Thomas Moers Mayer is co-chair of Kramer Levin's 45-attorney Corporate Restructuring and Bankruptcy Department.

Mr. Mayer has represented Official Committees of Unsecured Creditors in some of the largest cases in history, including General Motors, Chrysler, Capmark, Smurfit-Stone and Dana Corporation. Mr. Mayer has also played major roles in the largest municipal insolvencies, representing holders of $900 million in secured sewer warrants of Jefferson County, Alabama in that County's chapter 9 case and $1 billion in Certificates of Participation in the Detroit chapter 9. Mr. Mayer leads the Kramer Levin team focused on heavily indebted Puerto Rico and its instrumentalities. He currently assists Amy Caton in her representation of $2.4 billion of secured bonds issued by the Puerto Rico Electric Power Authority.

Mr. Mayer has also represented investors in financially distressed companies. His transactions include the 1991 acquisition of Wheeling-Pittsburgh Steel Corporation and the 2006 hostile takeover of WCI Steel Corporation, both through chapter 11 plans supported by the United Steelworkers of America. He is the leading scholar on trading claims and taking control of corporations in chapter 11, having authored or co-authored (with Chaim J. Fortgang) five published articles and the *Collier Bankruptcy Manual* chapter on the topic.

Chief Justice John Roberts of the United States Supreme Court appointed Mr. Mayer to the United States Judicial Conference Advisory Committee on Bankruptcy Rules for a three-year term starting October 1, 2014. Mr. Mayer is a member of the National Bankruptcy Conference, a non-partisan organization of approximately 60 leading lawyers, law professors and bankruptcy judges which provides bankruptcy advice to Congress. He is also a

Related Practices

Corporate Restructuring and Bankruptcy

Claims Trading and Distressed Investment Advice

Official Committees and Other Creditor Representations

Bankruptcy Litigation and Investigation

Distressed Mergers and Acquisitions

Distressed and Special Situations Lending

Chapter 11 Debtor Representation

Education

- J.D., magna cum laude, Harvard Law School, 1981
  Editor, *Harvard Law Review*, 1980-1981
- A.B., summa cum laude, Phi Beta Kappa, Dartmouth College, 1977

Bar Admissions

- New York, 1982

Clerkships

- Honorable J. Edward Lumbard, United States Court of Appeals for the Second Circuit, 1981 - 1982

Honors and Distinctions

- *Benchmark Litigation*, 2014-2015

Fellow of the American College of Bankruptcy, an honorary association of approximately 800 leading senior insolvency professionals.

- *The Best Lawyers in America*, 2006-2015
- *Chambers Global*, 2007-2015
- *Legal 500 US*, 2009-2014
- New York *Super Lawyers*, 2006-2014
- Adjunct Professor, Cardozo Law School (1998)

Professional Affiliations

- The Association of the Bar of the City of New York

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Todd F. Maynes

Professional Profile

Todd Maynes, a partner in Kirkland's Chicago office, focuses his practice on the tax aspects of debt restructuring, bankruptcy, and tax litigation. Todd has served as chairman of the Planning Committee for both the University of Chicago Federal Tax Conference and the Chicago-Kent College of Law Federal Tax Institute. He teaches bankruptcy taxation at Northwestern University School of Law, previously taught advanced income taxation at Chicago-Kent College of Law, and lectures frequently at the University of Michigan Law School. He is also a member of the National Bankruptcy Conference. He is co-chairman of the Kirkland & Ellis Finance Committee, chairman of the Kirkland & Ellis Benefits Committee, administrator for the Firm's retirement plans, and Tax Matters Partner for the Firm.

Todd has been the lead tax advisor in numerous major bankruptcies and restructurings, including Energy Future Holdings, United Airlines, Conseco, Calpine, Charter Communications, Visteon, and WR Grace. *Chambers USA* said that Todd has a "spectacular" reputation in the bankruptcy tax area, and is a "talented and very smart man." Todd was the principal tax attorney in structuring the Charter Communications bankruptcy and obtained a favorable IRS ruling on that transaction, called by the federal bankruptcy court as perhaps the "largest and most complicated prepackaged bankruptcy in history."

Todd has been listed in *The Best Lawyers in America, the Legal 500,* and as one of *Illinois' Super Lawyers*. He has published many articles on tax matters, speaks frequently at tax conferences, and is the author of the BNA Portfolio on Start-Up Expenses. The Legal 500 reports that Todd "is rated as '*a brilliant lawyer*' who is '*a fighter, but canny enough to know when to take a deal.'*"



Jim Millstein is the Founder and Chief Executive Officer of Millstein & Co., a financial advisory firm with 30 professionals in offices in Washington, D.C. and New York City. Representative engagements include advice to the Commonwealth of Puerto Rico in connection with the management of its $75 billion of institutional indebtedness; to US Airways in connection with the its acquisition of American Airlines out of Chapter 11; and to holders of $26 billion of secured claims against the merchant power subsidiary of TXU operating in Chapter 11.

From 2009 to March 2011, Mr. Millstein was the Chief Restructuring Officer at the U.S. Department of the Treasury. In that role, he was responsible for oversight and management of the Department's largest investments in the financial sector and was the principal architect of AIG’s restructuring and recapitalization.

Prior to joining the Treasury, Mr. Millstein served as Managing Director and Global Co-Head of

Corporate Restructuring at Lazard from 2000 to 2008. Selected engagements at Lazard include representation of the United Auto Workers in connection with the restructuring of their contractual relationships with GM, Ford and Chrysler from 2005 to 2007; Charter Communications in connection with its pre-packaged plan of reorganization under Chapter 11; the Republic of Argentina in connection with the exchange offer for its international bond indebtedness; WorldCom in connection with its Chapter 11 reorganization; United Pan-European Communications in connection with its pre-arranged plan of arrangement in the Netherlands and Delaware; and, Marconi in connection with its scheme of arrangement in the United Kingdom.

Before joining Lazard, Mr. Millstein was Partner and Head of the Corporate Restructuring practice at Cleary, Gottlieb, Steen & Hamilton. Significant engagements included representation of Daewoo Corporation in connection with its financial restructuring in Korea; the Disney Corporation in connection with the financial restructuring of EuroDisney in France; representation of the Pension Benefit Guaranty Corporation in LTV's Chapter 11 proceedings; representation of Pan-American Airlines in connection with its Chapter 11 reorganization; and, the Zell-Chilmark Fund in its acquisition of various troubled companies in and out of Chapter 11.

Mr. Millstein is an adjunct professor of law at Georgetown University Law Center, where he teaches Federal Regulation of Financial Institutions; and a Commissioner on the American Bankruptcy Institute's Commission to Study Reform of Chapter 11.

Mr. Millstein received a J.D. from Columbia Law School, where he was a Harlan Fiske Stone Scholar. He holds an M.A. in Political Science summa cum laude from the University of California, Berkeley. Mr. Millstein graduated summa cum laude with a B.A. in Politics from Princeton University.

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Edward R. Morrison

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ASSISTANT INFO

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Phone: 212-854-7954

Email: rjones3@law.columbia.edu

Areas of Teaching and Research

- Bankruptcy law
- Law and economics
- Corporate reorganization
- Contracts

Education

- University of Chicago, Ph.D. (Economics), 2003
- University of Chicago Law School, J.D., 2000
- University of Chicago, M.A., 1997
- University of Utah, B.S., 1994

Biography

Edward R. Morrison rejoined the Columbia Law School faculty in July 2014 as an expert in bankruptcy law and law and economics, including the causes and consequences of insolvency, both consumer and corporate. Over the course of a distinguished career, Morrison's scholarship has addressed corporate reorganization, consumer bankruptcy, entrepreneurship and small business finance, financial derivatives, the regulation of systemic market risk, and foreclosure and mortgage modification.

His research has been recognized by the bankruptcy bench and bar and has received support from the National Science Foundation and Pew Charitable Trusts, among other foundations. His current work studies patterns in inter-creditor agreements, the extent to which unexpected health expenditures cause defaults and consumer bankruptcy filings, the effects of bankruptcy law on entrepreneurship, and the costs and benefits of the bankruptcy code's special rules for financial contracts such as repos.

In 2012, Morrison received the John Wesley Steen Law Review Writing Prize from the American Bankruptcy Institute (ABI), along with Douglas Baird of the University of Chicago, for an article on the Dodd-Frank Act published in the ABI Law Review.

In addition to his work as a scholar, Morrison serves as a director of the American Law & Economics Association, is a conferee of the National Bankruptcy Conference, and has been appointed by Chief Justice John G. Roberts, Jr. to serve as a member of the Advisory Committee on Bankruptcy Rules. He is currently an editor of the Journal of Legal Studies and was previously an associate editor of the American Law & Economics Review.

Morrison was a member of the Columbia Law School faculty from 2003 to 2012, serving as the Harvey R. Miller Professor of Law and Economics from 2009 to 2012 and as co-director of the Richard Paul Richman Center for Business, Law, and Public Policy. He most recently served as the Paul H. and Theo Leffmann Professor of Commercial Law at the University of Chicago Law School.

Before working in academia, Morrison clerked for Judge Antonin Scalia of the Supreme Court of the United States and for Judge Richard A. Posner of the 7th Circuit Court of Appeals.

Selected Publications
Books

- *Economics of Bankruptcy*. Edward R. Morrison, ed. Edward Elgar Press, 2012

Book Sections

- "The Economics of Bankruptcy: An Introduction to the Literature," in *Economics of Bankruptcy*, Edward R. Morrison, ed. Edward Elgar Press, 2012
- "Timbers of Inwood Forest, the Economics of Rent, and the Irrelevance of Supreme Court Precedent," in *Bankruptcy Stories*, Robert K. Rasmussen, ed. Foundation Press, 2007
- "Derivatives and Systemic Risk: What Role Can the Bankruptcy Code Play?" in *Systemic Financial Crises*, Douglas D. Evanoff and George G. Kaufman, eds. World Scientific Press, 2005

Journal Articles

- "Mortgage Modification and Strategic Default: Evidence from a Legal Settlement with Countrywide," (with Christopher J. Mayer, Tomasz Piskorski, Arpit Gupta) in *American Economic Review*, forthcoming
- "Dodd-Frank for Bankruptcy Lawyers." 19 *American Bankers Institute Law Review* 287 (2011)
- "Discussion Remarks, Legal Aftershocks of the Global Financial Crisis, Panel 3: Bankruptcy and Restructuring of Financial Institutions." 6 NYU Journal of Law and Business 241 (2010)
- "Bargaining around Bankruptcy: Small Business Distress and State Law." 38 *Journal of Legal Studies* 255 (2009)
- "Creditor Control and Conflict in Chapter 11." 2 *Journal of Legal Analysis* 511 (2009)
- "Is the Bankruptcy Code an Adequate Mechanism for Resolving the Distress of Systemically Important Institutions?" 82 *Temple Law Review* 449 (2009)
- "A New Proposal for Loan Modifications." 26 *Yale Journal of Regulations* 417 (2009)
- "Bankruptcy's Rarity: Small Business Workouts in the United States." 5 *European Company and Financial Law Review* 172 (2008)
- "Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small Business Bankruptcies." 50 *Journal of Law and Economics* 381 (2007)
- "Adversary Proceedings in Bankruptcy: A Sideshow." 79 *American Bankers Institute Law Review* 951 (2005)
- "Derivatives and the Bankruptcy Code: Why the Special Treatment?" 22 *Yale Journal of Regulations* 91 (2005)
- "Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges." 13 *American Bankers Institute Law Review* 641 (2005)
- "Serial Entrepreneurs and Small Business Bankruptcies." 105 Columbia Law Review 2310 (2005)
- "Bankruptcy Decision Making." 17 *Journal of Law, Economics and Organization* 356 (2001)
- "Judicial Review of Discount Rates Used in Regulatory Cost-Benefit Analysis." 65 *University of Chicago Law Review* 1333 (1998)
- "Impact of the Salt Lake City Airport on the Utah Economy." 53 *Utah Economic and Business Review* 1 (1993)
- "Off-Balance Sheet Risks: What Are They and Why is Their Disclosure Important?" 11 *Journal of Accounting Education* 313 (1993)

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Harold S. Novikoff
Partner, Restructuring and Finance

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51 West 52nd Street
New York, NY 10019

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HAROLD S. NOVIKOFF

Harold S. Novikoff is a partner and the chair of the Restructuring and Finance Department at Wachtell, Lipton, Rosen & Katz. He focuses on creditors' rights, bankruptcy, debt restructurings and financial market transactions. Mr. Novikoff has 39 years of professional experience in representing the principal lenders, bondholders and underwriters in Chapter 11 cases and out-of-court debt restructurings of a wide range of public and private companies; purchasers of and investors in financially distressed companies; and dealers and other market participants in connection with derivatives, repurchase agreements, securities loans and other financial market transactions.

In addition to his role in the firm's restructuring and finance practice, Mr. Novikoff has chaired and taught numerous continuing legal education and professional programs on a broad spectrum of financial, creditors' rights and bankruptcy-related topics, including Chapter 11 plans and disclosure statements, distressed company and debt purchases, valuation of companies in Chapter 11, special protections for financial market transactions in bankruptcy, structuring of loans and other credit transactions and avoidance actions. He is a co-author of *Collier on Bankruptcy*, and an author of numerous published articles and outlines on bankruptcy-related topics.

Mr. Novikoff is a commissioner of the ABI Commission to Study Chapter 11 Reform, a former chair of the Committee on Bankruptcy and Corporate Reorganization of the Association of the Bar of the City of New York, a member of the Executive Committee of the National Bankruptcy Conference, a fellow of the American College of Bankruptcy, and a member of the Steering Committee of the Board of Visitors of Columbia Law School.

Recent representations include the United States Treasury in the rescue of Fannie Mae and Freddie Mac, JPMorgan (the largest secured creditor) in the Lehman Brothers and MF Global bankruptcies cases and major creditors of Thornburg Mortgage, Collins & Aikman, KKR Atlantic and Pacific, Axon Financial, Victoria Finance, Dreier, American Home Mortgage, 360networks and National Century Financial Enterprises.

Mr. Novikoff received his bachelor's degree with distinction from Cornell University. He received his juris doctor from Columbia University School of Law, where he was a member of the Board of Editors of the *Columbia Law Review*.

PACHULSKI STANG ZIEHL & JONES



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13th Floor
Los Angeles, CA 90067-4003

Isaac M. Pachulski

Tel: 310.277.6910 | ipachulski@pszjlaw.com

EDUCATION

University of California at Los Angeles (B.A. *summa cum laude* 1971)

Harvard Law School (J.D. *summa cum laude* 1974)

BAR AND COURT ADMISSIONS

1974, California

United States Supreme Court

Mr. Pachulski specializes in corporate reorganization, insolvency, and bankruptcy law. He has represented debtors, significant creditors, and official and unofficial committees and creditor groups in cases around the country. He also has devoted a significant portion of his practice to appellate matters. Mr. Pachulski's wide-ranging experience in the insolvency area includes the representation of a trustee for a failed clearing broker in a proceeding under the Securities Investor Protection Act.

Mr. Pachulski is widely recognized as an expert in his field. He is an active member of both the National Bankruptcy Conference (where he chaired the Chapter 11 Committee) and the International Insolvency Institute, as well as a fellow of the American College of Bankruptcy. He has been named in Who's Who Legal (for Insolvency & Restructuring), the Best of the Best (Legal Media Group), 500 Leading Lawyers in America; Southern California Best Lawyers in America (2011 & 2012); Best Lawyers in America (every year since 1993); and Super Lawyers for Bankruptcy & Creditor/Debtor Rights (*Super Lawyers Magazine*; every year since 2004). Mr. Pachulski holds an AV Preeminent Peer Rating, Martindale-Hubbell's highest recognition for ethical standards and legal ability.

He received his J.D., *summa cum laude*, from Harvard University, earning the distinguished Fay Diploma for highest cumulative grade average. While at Harvard, he won the Sears Prize two years in a row and was a member of the *Harvard Law Review*. His BA was earned *summa cum laude* at University of California Los Angeles. He is admitted to practice in California and resident in our Los Angeles office.

Representations

Chapter 11 debtors: Mariner-Post Acute Network; Public Service Company of New Hampshire; Cherokee, Inc.; Restaurant Enterprises Group; Wilson Foods

Debtholders in chapter 11 cases: Enron; Owens Corning; Lehman Brothers; Tribune Company; Scotia Pacific; Delphi Corporation; Calpine; Adelphia Communications

Reported Cases

U.S. Bancorp Mortgage Corp. v. Bonner Mall Partnership, 513 U.S. 18 (1994) (counsel for amicus)

Chemical Bank v. First Trust of N.Y. (In re Southeast Banking Corp.), 156 F.3d 1114 (11th Cir. 1998)

United States v. Wyle (In re Pacific Far East Lines), 889 F.2d 24 (11th Cir. 1989)

First Fidelity Bank v Public Service Co. (In re Public Service Co.), 879 F.2d 987 (1st Cir. 1989)

Willamette Waterfront Ltd. v. Victoria Station Inc. (In re Victoria Station Inc.), 875 F.2d 1380 (9th Cir. 1989)

Danning v. Bozek (In re Bullion Reserve), 836 F.2d 1214 (9th Cir. 1988)

Landes Constr. Co. v Royal Bank of Canada, 833 F.2d 1365 (1987)

Sambo's Restaurants v. Wheeler (In re Sambo's Restaurants), 754 F.2d 811 (9th Cir. 1985)

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Aoki v Shepherd Mach. Co. (In re J.A. Thompson & Son), 665 F.2d 941 (9th Cir. 1982)

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C.F. Brookside Ltd. v. Skyview Mem. Lawn Cemetery (In re Affordable Hous. Dev. Corp.), 175 B.R. 324 (BAP 9th Cir. 1994)

Professional Affiliations

Member, National Bankruptcy Conference (former chair, Chapter 11 Committee)

Member, International Insolvency Institute

Fellow, American Bankruptcy College

Programs and Lectures

International Insolvency Institute; Financial Lawyers Conference; American Bankruptcy Institute; National Conference of Bankruptcy Judges; Turnaround Management Association

Publications

"Cramdown and Valuation Under Chapter 11 of the Bankruptcy Code," 58 *N. C.L. Law Review* 925 (1981)

"*Levy v. Cohen*: Another Pitfall for Creditors in Bankruptcy Proceedings," 53 *Los Angeles Bar Journal* 278 (1977)

Hon. Pamela Pepper Bio

Education:
Cornell Law School, Ithaca, New York, Juris Doctor, 1989
Northwestern University, Evanston, Illinois, Bachelor of Speech, 1986
Employment:
U.S. Bankruptcy Judge 2005-
Private Practice, 1997-2005
Marquette University Law School, Adjunct Professor, 1999-2003
Eastern District of Wisconsin, Assistant U.S. Attorney, 1994-97
Northern District of Illinois, Assistant U.S. Attorney, 1990-94
Cappel, Howard, Knabe & Hobbs, Montgomery, Alabama, Clerk, 1990
U.S. Court of Appeals, 11th Circuit, Hon. Frank M. Johnson, Clerk, 1989-90
Jones, Day, Reavis & Pogue, Chicago, Clerk, 1989
Jones, Day, Reavis & Pogue, New York, Clerk, 1988
Professional Associations:
State Bar of Wisconsin, Board of Governors, Chair
Milwaukee Bar Association, President-Elect
Association for Women Lawyers, Treasurer
Seventh Circuit Bar Association, Editor of The Circuit Rider
Eastern District of Wisconsin Bar Association, Program Director
Federal Defender Services of Eastern Wisconsin, Inc., Board Member
Wisconsin Public Defender, Board Member

Hon. Brendan L. Shannon

Brendan Linehan Shannon is a United States Bankruptcy Judge for the District of Delaware. Judge Shannon received his undergraduate degree from Princeton University, and his law degree from the Marshall-Wythe School of Law at the College of William and Mary in Williamsburg, Virginia. In addition to his Chapter 11 business reorganization docket, Judge Shannon also handles all Chapter 13 consumer bankruptcy cases filed in the District of Delaware.

Prior to his appointment to the bench, Judge Shannon was a partner with Young Conaway Stargatt & Taylor, LLP in Wilmington, Delaware. At Young Conaway, Judge Shannon primarily represented corporate debtors and official committees in Chapter 11 cases. Judge Shannon is a member of the Delaware State Bar Association, the American Bar Association, the American Bankruptcy Institute and the Rodney Inns of Court in Wilmington, Delaware.

Judge Shannon serves as an adjunct professor in the Bankruptcy L.L.M. Program at St. John's University School of Law in New York and at Widener School of Law in Delaware. He serves on the Board of Editors of Collier on Bankruptcy (16th ed.) and is a contributing author for several chapters covering the Federal Rules of Bankruptcy Procedure. He is a member of the National Bankruptcy Conference, and serves on the Board of Directors of the Delaware Council on Economic Education.



Catherine Steege is a partner with the firm of Jenner & Block LLP. She is co-chair of the firm's Bankruptcy Litigation practice group, a fellow of the American College of Bankruptcy, an adjunct professor at John Marshall Law School and a member of the Panel of Trustees for the Northern District of Illinois. In addition to a traditional bankruptcy practice, she has represented numerous parties in complex bankruptcy litigation matters including her representation of the Sentinel Management Group Litigation Trustee, the Magnatrax Litigation Trust, the NKK Litigation Trust and the Trustees of Emerald Casino Inc. and Consolidated Industries Corp. She recently argued in the United States Supreme Court on behalf of Wellness International Network in the case *Wellness International Network v. Sharif*. She represented the examiner in the Lehman Brothers chapter 11 case and authored the sections of the Lehman Brothers Examiner's Report that considered potential avoidance actions against various financial institutions.

Nathan Van Duzer

Board Member
Lucchese Boot Co
June 2014 – Present (1 year)El Paso, Texas

Managing Director Special Situations
Fidelity Investments
2001 – Present (14 years)

Associate
Ropes & Gray LLP
1997 – 2001 (4 years)

Platoon Leader and Group Engineer
US Army Corps of Engineers
1991 – 1994 (3 years)

MILLSTEIN & CO.



Team

Jane Vris

Jane Vris is General Counsel and Partner at Millstein & Co.

During her legal career, including as a Partner at Wachtell, Lipton, Rosen & Katz, Ms. Vris has advised boards, special committees, creditors, potential purchasers of assets from distressed companies, and equity investors in companies emerging from Chapter 11. Ms. Vris's clients have included Deutsche Bundesbank, the central bank of Germany, which held over $12 billion in claims in the Lehman U.S. Bankruptcy cases; J.P. Morgan Securities, Inc., as the equity backstop provider for Northwest Airlines during its bankruptcy proceedings; and, Entergy Corp. in connection with the Chapter 11 case of its subsidiary, Entergy New Orleans, following Hurricane Katrina. Ms. Vris most recently served as a Partner at Vinson & Elkins and was a Founding Partner of Cronin & Vris.

Ms. Vris is a member of the National Bankruptcy Conference, which consists of approximately 60 of the top bankruptcy lawyers, law professors and judges, as well as other leading professional bankruptcy organizations. She has been designated by Chambers USA as one of "America's Leading Lawyers for Business", named a "New York Super Lawyer" by New York Super Lawyers and is included in the "Guide to the World's Leading Insolvency and Restructuring Lawyers" by Legal Media Group (Euromoney) and the International Who's Who of Insolvency & Restructuring Lawyers. Ms. Vris writes regularly on the latest developments in her field and is a frequent speaker at professional conferences and programs.

Ms. Vris received a J.D. from New York University (NYU) School of Law and served as Managing Editor of the NYU Law Review. She holds a B.A. from the University of Pennsylvania, magna cum laude. Ms. Vris is a Member of the Bar of New York, the District of Columbia and Maine.

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Millstein advised "US Airways Group on its efforts to merge v
American Airlines"

- BusinessWeek, 9/20/12

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Alice Chong
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Principal Group
Michael Duran
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BIOGRAPHY FOR JUDGE EUGENE R. WEDOFF

Eugene R. Wedoff has served as a bankruptcy judge in the Northern District of Illinois (in Chicago) since 1987 and as chief judge from 2002 to 2007. Judge Wedoff was a member of the Advisory Committee on Bankruptcy Rules from 2004-2014 and has served as its chair after 2010.

Judge Wedoff is currently the immediate past-president of the National Conference of Bankruptcy Judges. He also served as a member of the NCBJ's Board of Governors, as its secretary, and as chair of its education committee.

He is a member of the American Bankruptcy Institute and has served as an officer and member of its Executive Committee. He is a fellow of the American College of Bankruptcy and a member of the National Bankruptcy Conference. He presided over the Chapter 11 reorganization of United Air Lines.

Judge Wedoff is the author of the chapter on professional employment in Queenan, Hendel and Hillinger, Chapter 11 Theory and Practice (LRP Publications, 1994), and has been an associate editor of the American Bankruptcy Law Journal.

Judge Wedoff is a frequent lecturer and has served as a member of the Federal Judicial Center's Committee on Bankruptcy Judge Education. In 2009, he received the Lawrence P. King Award from the Commercial Law League, and in 1995, he received the Excellence in Education Award from the NCBJ.

Third Party Oversight

Thursday, May 28, 2015
10:15 a.m.-11:15 a.m.

Harold S. Novikoff
Hon. Robert D. Drain
Ken Liang

NATIONAL BANKRUPTCY CONFERENCE
COMMITTEE TO RETHINK CHAPTER 11

Corporate Governance Considerations

Reasons for a Change; Potential Deficiencies under Current Law and Practice

- **Debtor in possession** – (a) governs unless a trustee is appointed, (b) controls the filing of a plan during exclusivity period, and (c) entitled to deference and/or protection of business judgment rule with respect to a wide spectrum of decisions that are outside the ordinary course of business (including financings, sales and settlements)
    - May be poor manager
    - May be unsuited for restructuring (business and plan), sale, liquidation, litigation or investigatory role
    - May be heavily influenced by ownership of equity, opportunity for continued employment and/or personal compensation
    - May lack credibility with DIP lenders (actual or potential), creditors, employees and/or other prepetition stakeholders
        - DIP lenders respond with tougher covenants and control provisions
        - May undermine justification for courts to defer to debtor's business judgment if court believes that management/board is weak or compromised
- **Chapter 11 Trustee** – (a) broad managerial, restructuring and investigatory powers, (b) appointment terminates plan exclusivity, and (c) generally selected by U.S. Trustee (subject to Court approval) after consultation with parties in interest
    - In practice, chapter 11 trustees have been rarely sought and appointed,
        - Even in situations involving fraud, mismanagement and/or loss of trust by management, the parties typically opt for a CRO or the equivalent (*e.g.* Enron, Worldcom, Lehman)
        - Recent exceptions are MF Global (alleged prepetition misuse of customer funds) and Thornburg Mortgage (alleged postpetition DIP misconduct)
    - Biggest deficiency is the lack of consistent and complete creditor input. Voting contemplated by section 1104(b)(1) rarely occurs and is limited to unsecured creditors (which seems inappropriate in capital structures dominated by secured debt)
    - Trustee may not be suitable for operating a business

- Trustees often involve a new layer of expenses, including a new set of attorneys and financial advisors carrying out a broad range of activities

- Appointment may be unpredictable, and experience with chapter 11 trustees is generally regarded as uneven at best

- Loss of control and exclusivity are strong disincentives for a debtor to consent to the appointment of a trustee

- **Chief Restructuring Officer ("CRO")/Crisis Management Team** -- (a) not expressly contemplated by the Bankruptcy Code, (b) typically selected and hired by the debtor, and (c) role in DIP governance will vary on a case-by-case basis

    - In practice, selection may be heavily influenced by senior secured creditors

    - Responsibilities and reporting to creditor constituencies and other stakeholders may be unclear

    - Fiduciary duties are unclear if they are not corporate officers

- **Examiner** – (a) investigative role only, (b) mandatory appointment upon request of a party in interest in many cases, regardless of the need for an investigation, (c) disqualified from prosecuting identified causes of action, and (d) selected by U.S. Trustee (subject to Court approval) after consultation with parties in interest

    - Generally, an examiner is not a solution to address governance concerns

    - Investigations can be quite expensive and may cause delays

    - Examiner's report may be informative but of little or no evidentiary value in a litigation context (may be helpful in a settlement context)

Desirable Attributes of a Governance Proposal for Chapter 11 Cases

- Achievable quickly and with little litigation

- An individual with a defined senior role in the debtor's governance, either inside or outside the debtor's senior management team, is capable, widely trusted by the debtor and major stakeholders, has the authority to do what is necessary under the particular circumstances of the chapter 11 case, and warrants reasonable business judgment deference by the court

    - This includes being sufficiently competent and credible as to reduce the desire/need for many extraordinary controls in DIP financing and use of collateral orders

- Respects state law corporate governance statutes/caselaw

- Minimize disincentives for commencing a chapter 11 case or for management/board to remain with the debtor and to provide cooperation and assistance with the restructuring

- The individual does not require a new set of a attorneys and financial advisors carrying on a broad range of activities

- *For purposes of convenience only, we will refer to the individual in this new governance proposal as a "Responsible Party" or "RP"*

"Clean Slate" Corporate Governance Proposal

- Motion for Appointment. After a motion brought upon notice and a hearing by the debtor or a Proposing Party (defined below), an RP may be appointed and an RP Plan (defined below) may be made specified by the court. Such motion shall specify a proposed RP and RP Plan (defined below).

    - If the debtor is the movant:

        - No showing of cause is required.

        - Appointment of an RP nominated by the debtor or a Proposing Party, and specification of an RP Plan, are mandatory.

    - If a Proposing Party is the movant:

        - Cause must be shown.

        - If cause is shown, appointment of an RP nominated by the debtor or a Proposing Party, and specification of an RP Plan, are mandatory.

    - It is contemplated that the RP and the RP Plan will be the subject of early negotiations among the debtor, creditors' committee, major prepetition lenders and sources of DIP financing to arrive at a consensual arrangement that is appropriate for each particular case. If consensus is not reached:

        - The debtor and any Proposing Party, as the case may be, may file responsive pleadings to such a motion in which they may propose an alternative RP and RP Plan.

        - All parties in interest have standing to be heard in support of or in opposition to any such motion, RP or RP Plan.

    - If the court determines to appoint an RP, it must select from the RP candidates proposed by the debtor and the Proposing Parties.

    - The court has discretion to change proposed RP Plan provisions, and is not limited to the party's proposals.

- After a motion brought upon notice and a hearing by the debtor or a Proposing Party, a previously appointed RP may be replaced and/or a previously specified RP Plan may modified, in each case for cause shown.

- Timing: The bankruptcy court, when determining whether to appoint an RP and the scope of such RP's duties, shall take into consideration the timing of such request. If the timing is suspect (*e.g.*, if the court believes that parties are using RP motions for "gamesmanship" purposes), the court may deny a motion for an RP even if cause may otherwise exist. The hearing on an RP motion shall be conducted within 30 days of the filing of the motion unless the Court, for cause shown or *sua sponte*, determines otherwise.

- Proposing Parties.

  - The following are eligible as Proposing Parties:

    - Any official committee, unless otherwise specified in the order appointing such committee.

    - One or more creditors holding in the aggregate more than $1 million of claims of any one or more classes (secured or unsecured, senior or subordinated).

    - A union representing more than one-third of the debtor's employees.

    - Any other person(s) authorized to do so by an order of the bankruptcy court.

  - The U.S. Trustee is not a Proposing Party, but has standing to be heard in support of or in opposition to any motion for appointment of an RP, and any proposed RP or RP Plan.

  - If the debtor has assets of less than $10 million, only the debtor may propose that an RP be appointed. Once the debtor proposes the appointment of an RP, then any Proposing Party may propose an alternative RP or RP Plan.

- RP Plan.

  - The order appointing the RP will include an "RP Plan," which will consist at a minimum of provisions specifying:

    - The terms of the RP's engagement and responsibilities, including compensation, indemnification and insurance.

    - The duties of the RP, to whom the RP reports and whether the debtor's management will report to the RP.

        - Any changes or restrictions in the role or authority of the pre-existing board of directors and/or officers. Subject to the Special Grounds requirement described below, it is contemplated that the RP may, if so specified in the RP Plan, have all of the powers currently available to a chapter 11 trustee, including taking over some or all of the responsibilities of the board and/or officers, proposing a chapter 11 plan and/or requiring that certain corporate action may be taken only with the RP's authorization, consent or approval.

        - Whether the RP is a company officer or court appointee. *N.B.* Court appointment of an RP as a corporate officer may be subject to state corporate law.

        - Whether the RP may retain separate professionals. It is contemplated that the RP will use the debtor's professionals unless (and then, only to the extent) that there is a need for the RP to retain his own.

        - If the RP is to supplant the Board with respect to some or all of its duties, and Special Grounds are not present, it may only be for cause shown by clear and convincing evidence, and such displacement is limited to the matters for which cause has been shown.

    - Unless terminated sooner under the RP Plan, the RP will be terminated and discharged upon dismissal or conversion of the case and upon substantial consummation of a confirmed chapter 11 plan.

- <u>Cause; Standards for Selecting Among Proposed RPs and RP Plans</u>.

    - In the context of a motion by a Proposing Party for the appointment of an RP, "cause" can include (this is a non-exhaustive list):

        - Fraud, dishonesty, incompetence or gross mismanagement by current management before or after the commencement of the case ("Special Grounds").

        - The absence of material financial controls.

        - The vacancies of two or more officer positions in the company.

        - Material restatements of the company's financial statements in the past 18 months.

        - A demonstrated need for increased operational efficiencies or a substantial operational reorganization of the debtor's business.

        - There are or have been significant governmental investigations of the company or its officers, employees or directors within the past 18 months.

- It is reasonably contemplated that there will be substantial sales or other material transactions out-of-the-ordinary course of the debtor's business during the pendency of the chapter 11 case that will require experience or expertise that debtor's management lacks and will likely be required for a successful reorganization.

- The debtor's management is deficient or lacks experience in an area of operational, transactional, financial or restructuring competency that will likely be required for a successful reorganization.

- The debtor's board of directors is wholly interested.

- The appointment is in the best interests of the estate.

- In the case of an RP Plan providing for the RP to supersede, in whole or in substantial part, the debtor's board of directors, Special Grounds must be shown unless the debtor consents (the "Special Grounds Requirement").

- In the case of a motion to replace an RP or modify an RP Plan, cause should be limited to matters occurring, arising or discovered after the prior appointment or specification.

- In choosing the RP and specifying the terms of the RP Plan, the court shall take into consideration, among other things (this is a non-exhaustive list):

  - The nature of the cause shown (*e.g.* if the cause shown was a deficiency in financial controls, the RP selected should have experience in financial controls and the RP Plan should give the RP powers and responsibilities relating to financial controls).

  - The views of the parties in interest.

  - The qualifications of the candidates for the RP position (including, to the extent relevant, their knowledge of and experience with the debtor's business, the relevant markets and industries, sales of businesses and assets, reorganization practices and chapter 11 plan negotiations).

  - The status of any plan negotiations (including those occurring prior to the commencement of the case).

  - The likelihood that a substantial portion of the estate assets will be transferred during the case.

  - The conduct of the debtor, its insiders and creditors prior to the commencement of the case.

  - The extent to which insiders control the debtor.

        - The complexity of the debtor's corporate and capital structure.

        - Any other factors reasonably likely to contribute to the prospects for a chapter 11 plan of reorganization to be confirmed under section 1129(a) (including section 1129(a)(8)) within a reasonable time frame in light of the size and nature of the debtor's business, operations, assets and liabilities.

        - The best interests of the estate.

    - The RP should hold no substantial conflicts of interest with the debtor's estate that are likely to affect the performance of the RP's duties, but in the case of an employee of the debtor may hold claims or equity interests that are not materially disproportionate to his role as employee.

        - The RP may be an employee of the debtor, a crisis manager, an advisor, an accountant, a lawyer or a business professional.

        - All of the RP's interests in the debtor or connections to other parties in the case must be disclosed publicly in a filing with the court prior to entry of the order appointing the RP (similar to Rule 2014 disclosure)

- Greater Deference to a Debtor if an RP Has Been Appointed. (*N.B.* some of the following require coordination with other projects of the Rethink Committee);

    - Decisions by the debtor's management will be entitled to court deference in the context of motions for authority to take action outside the ordinary course of business only if (a) an RP has been appointed and (b) if so specified in the RP Plan, supported by the RP.[1]

    - Prohibitions on DIP lender/adequate protection control covenants are applicable only if an RP has been appointed.

    - Unless otherwise specified in the RP Plan, appointment of an RP provides an automatic 3 month extension of any exclusivity periods (but not beyond any applicable statutory cap on exclusivity).

    - No chapter 11 trustee may be appointed after the appointment of an RP. (The RP can be replaced by another RP as described above.) An examiner may be appointed, for cause shown (not mandatory), after the appointment of an RP to conduct an investigation, but only if and to the extent that the RP Plan does not provide for such an investigation.

[1] This does not affect the insulation from liability otherwise available to officers and directors under the business judgment rule.

- Other Matters.
    - The RP has standing to file pleadings with the bankruptcy court, and may be requested by the bankruptcy court to appear to address questions from the court.

Reorganization Value and Option Value

(no written materials for this topic)

Thursday, May 28, 2015
11:35 a.m.-12:35 p.m.

Donald S. Bernstein
Professor Anthony Casey
James E. Millstein

Bargaining and Plan Negotiation

Thursday, May 28, 2015
1:30 p.m.-2:30 p.m.

Thomas Moers Mayer
Isaac M. Pachulski
Hon. Eugene R. Wedoff

TO: NBC Chapter 11 Committee to Rethink Chapter 11
FROM: Isaac M. Pachulski and
Thomas Moers Mayer
DATE: May 21, 2015

M E M O R A N D U M

TO: NBC Chapter 11 Committee to Rethink Chapter 11
FROM: Isaac M. Pachulski and
Thomas Moers Mayer
RE: Classification/Voting
DATE: May 21, 2015

The purpose of this Memorandum is to present a framework for "rethinking" voting and classification (and related disclosure issues) in the context of "rethinking" chapter 11. This Memorandum also summarizes the recommendations adopted by the Conference.

A. Introduction.

These issues of voting and classification are related, because voting is by class. From the standpoint of "creditor democracy," both issues must be considered from the perspective of why voting on a plan matters, and how the vote of creditors within a class to accept a plan can affect the rights of dissenting creditors within that class—and vice versa.

As described below, the most important consequence of a class vote is that it determines the level of economic protection to which the dissenters are entitled. This basic point is critical, because it requires us to determine (i) the rationale for making the rights of a dissenting creditor within a class turn on the behavior of other class members who accept or reject a plan; and (ii) whether the statutory construct for voting and classification comports with that rationale.

If there is a disconnect between the two, then something is wrong with the system. Today, such a disconnect arguably exists under the current system to the extent that it permits the rights of class members whose economic interest lies in maximizing the economic return on claims within the class to depend on the vote of (i) parties whose primary economic interests may conflict with maximizing the value of such claims, or (ii) parties whose vote is out of proportion to their actual economic interest or exposure to claims within the class.

The importance of the class vote—and of the integrity of that vote—lies primarily in the fact that the impact of the class vote on the rights of dissenters in the class under the Bankruptcy Code is far greater than it was under Chapter X of the former Bankruptcy Act. Under former Chapter X, a plan had to be "fair and equitable" in order to be confirmed *whether or not* it was accepted by the requisite majorities of each class. *See* Bankruptcy Act § 221(2). Thus, even if creditors in a particular class were outvoted, they were still entitled to "fair and equitable" treatment. As a result, a creditor in a class had less cause to be concerned about conflicting interests of other members of the class, because the dissenting creditor would in all events be entitled to "fair and equitable" treatment.

The Bankruptcy Code changed this construct; dramatically. Under chapter 11, the "fair and equitable" requirement is applied only to the dissenting class or classes, and not to all classes. *See* 11 U.S.C. § 1129(b). The same is true of the requirement that a plan "not discriminate unfairly." As a result, the only economic protection to which a dissenting creditor is entitled if it "loses" the class vote is that of the "best interests" test under Section 1129(a)(7) of the Code. That test requires only that the dissenting creditor receive at least what it would receive in a chapter 7 liquidation. That is a pretty easy standard for most plans to meet. Thus, the dissenting creditor's economic rights and entitlements change dramatically depending on the vote of others within its class.

The implicit rationale for this construct is the commonality of economic interest of the holders of claims within a class: That, in part, explains why Section 1122 requires that claims within a class be "substantially similar." If holders of the requisite majority in number and amount of claims that have the same economic interest in maximizing the recovery on claims in the class accept the plan, the self-interested vote of those with a common economic interest is a fair substitute for the enhanced protection afforded by the "fair and equitable" and "not discriminate unfairly" requirements. Under such circumstances, it is fair to limit the rights of the dissenting minority based on plan acceptance by a like-interested majority.

The basic premise for this construct, however, breaks down when the vote of parties within a class is based on economic interests that may have nothing to do with maximizing the value of the claim within the class, and may instead be predicated on interests which are collateral to, or even adverse to, the interests represented by claims within a class. The construct also breaks down when parties are able to cast votes which are all out of proportion to their actual economic interest in the class.

Conversely, it is at least arguable that the implicit premise for imposing more rigorous requirements for plan confirmation when the dissenting vote is 34% in amount or 50% in number of a class is that the dissenters are voting the economic interest that attaches to those claims. It would be difficult to articulate a policy rationale for allowing holders of claims in a class whose economic interests conflict with the interests of the claims in the class to block a plan that is acceptable to the holders of the requisite majority in number and amount of claims held by parties whose economic interests lie primarily in maximizing the value of the claims within the class.

Classification also has considerable substantive significance with respect to the treatment to which class members are entitled that goes beyond voting issues. In particular, the classification of a claim or interest determines the treatment to which it is entitled in comparison to other claims or interests of equal rank and priority. If a claim or interest is classified in the same class as other claims or interests of equal rank, it is entitled to the "same treatment" as all other claims or interests in its class, "unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest." *See* 11 U.S.C. § 1123(a)(4). In contrast, if claims or interest of equal rank and priority are separately classified in two or more classes, then: (i) if an equal-ranking class accepts the plan, any claim or interest in that class is entitled to no protection respecting its comparative treatment to claims or interests in the other equal-ranking class(es), other than the minimal protection provided by the "best interests" test; and (ii) if one of the equal ranking classes rejects the plan, a claim or interest in that class is entitled to have the plan "not discriminate unfairly" against the dissenting class in comparison to the other class(es) of equal rank,--which is a weaker standard than the "same treatment within a class" requirement of Section 1123(A)(4).

We submit that a plan proponent should not be able to use the separate classification of claims or interests of equal rank in this fashion to circumvent the fundamental bankruptcy principle of equality of treatment, absent a good business justification for the disparate treatment of claims or interests of equal rank. The fact that claims of equal rank may be "different" in some other respect should not be grounds for separate classification or disparate treatment over the objection of a dissenting creditor. The Committee recommends addressing this problem with amendments to Section 1129(b)(1) as set forth below.

B. Issues Considered and Recommendations.

1. Crossover Holdings and Conflicts of Interests Within a Class.

The vote-related issue derived from the considerations outlined in the introduction that has received considerable attention at Conference meetings is that of crossover-voting and conflicts of interest within a class. Crossover holdings among multiple classes of debt can skew plan voting where there is a contest over the allocation of assets between two classes (or among multiple classes), and holders of claims with a predominate economic interest in one class can

cast the "swing" votes in a conflicting class. As cases involve more complex capital structures, with substantial trading of claims in multiple classes with potentially conflicting interests, there is a greater likelihood of cross holdings and of creditors whose economic interests are weighted in one class casting the deciding vote in another class with which the first class is in conflict.

This topic has been controversial. One view holds that the existing case law does not address this issue adequately, and a legislative remedy would be appropriate. Another view is that cross-holdings are nothing new and predate the 1970's; that there is nothing wrong with a creditor voting claims in one class to protect or further its interests as a creditor in another class; and that trying to remedy this problem would involve the impossible task of ascertaining a creditor's motivation in voting.

The Conference has discussed potential legislative solutions to this issue, in the form of amending the statutory grounds for vote legislation under Section 1126(e). Even if adopted, however, any such legislative solution would be inadequate without a concomitant expansion of the disclosure requirements imposed on individual creditors. Today, there is nothing in the Code or Rules that requires a creditor voting on a plan to disclose claims or interests in other classes. Even where a party appears before the court claiming to be a "creditor" in the case, there is no requirement that the party disclose its holdings.

Indeed, in proposing the recent amendments to Bankruptcy Rule 2019, the Rules Advisory Committee specifically *rejected* the Conference's recommendation that individual creditors seeking relief from the court, or opposing relief sought by others, be required to disclose their holdings across the capital structure. Moreover, although the initial draft of the amended Rule would have empowered (but not required) the court to order such disclosure from a creditor appearing before the court, even that watered-down discretionary provision was eliminated in the final draft of the proposed amendment. This background is important, because any statutory construct that enabled the court to regulate crossover voting would have to include disclosure requirements far greater than anything ever proposed in connection with the amendment of Rule 2019, potentially requiring every creditor that votes to disclose on its ballot all claims held in all classes.

This problem would of course be compounded in a case of publicly held debt. In the case of such debt, the voting agent receives only anonymous master ballots, which do not disclose the identities of the ultimate beneficial holders. Although such master ballots might include anonymous information about cross-holdings which the various tabulating brokers would obtain from beneficial holders, that information would be useless, unless ballots completed by the underlying beneficial owners (including a disclosure of crossover holdings) were received directly by the vote tabulation agent.

What follows is a summary of two versions of an amendment to Bankruptcy Code § 1126(e) that have previously been considered by the Conference. The disclosure issues outlined above would have to be addressed under either version.

a. Alternative Number 1 (Narrower Version).

In order to address the issue of crossover voting, section 1126(e) could be amended to read as follows:

> (e) On request of a party in interest, and after notice and a hearing, the court may designate the acceptance or rejection of a plan by a holder of a claim or interest if (i) such acceptance or rejection was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title, or (ii) such holder has, by reason of any direct or indirect claim against or interest in the debtor or an affiliate of the debtor, an interest that is both (I) adverse to the interest of the class of claims or interests to which such acceptance or rejection relates and (II) of greater importance and economic value to such holder than its claim or interest in such class.

A blackline to the current version of section 1126(e) follows:

> (e) On request of a party in interest, and after notice and a hearing, the court may designate ~~any entity whose~~the acceptance or rejection of ~~such plan~~a plan by a holder of a claim or interest if (i) such acceptance or rejection was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title, or (ii) such holder has, by reason of any direct or indirect claim against or interest in the debtor or an affiliate of the debtor, an interest that is both (I) adverse to the interest of the class of claims or interests to which such acceptance or rejection relates and (II) of greater importance and economic value to such holder than its claim or interest in such class.

b. Alternative Number 2 (Broader Revision).

With respect to the broader rewrite of section 1126(e) described below, some background is in order. Although section 1126(e) of the Code is derived from a provision of Chapter X of the former Bankruptcy Act (section 203 and former Bankruptcy Rule 10-305), voting and creditor democracy are, as noted above, more important under chapter 11 because the class vote determines whether members of the class are protected by the "fair and equitable" and "not discriminate unfairly" rules.

Whether for this reason or for some other, the House bill attempted to address situations where a creditor or equity holder voting a claim or interest in a class had a conflict of interest with that class, providing in what was then section 1126(e) of H.R. 8200 as follows:

> (e) On request of a party in interest, and after notice and a hearing, the court may designate for any class of claims or interests any entity that has, with respect to such class, a conflict of interest that is of such nature as would justify exclusion of such entity's claim or interest from the amounts and number specified in subsections (c) and (d) of this section.

The related Committee Report provision stated:

> Subsection (e) permits the court to designate for any class of claims or interest any person that has, with respect to that class, a conflict of interest that is of such nature as would justify exclusions of that person's claim or interest from the amounts and number specified in subsection (c) or (d). A person might have such a conflict, for example, where he held a claim or interest in more than one class. Exclusion from one class for voting purposes would not require his exclusion from the other class as well. The result is to overrule cases such as *Aladdin Hotel Corp. v. Bloom*, 200 F.2d 627 (8th Cir. 1953) , which, though not in the bankruptcy context, would appear to count votes for a reorganization plan motivated by an attempt to squeeze out a minority of a class. In that case, the conflict of interest of those voting for the plan was clear, but the court permitted the votes.

This language was ultimately deleted (apparently at the request of the Senate in Conference), but the floor statements said that:

> Section 1126 of the House amendment deletes section 1126(e) as contained in the House bill. Section 105 of the bill constitutes sufficient power in the court to designate exclusion of a creditor's claim on the basis of a conflict of interest.

This legislative history is generally discussed in *In re Dune Deck Owners' Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995). However, while the court in *Dune Deck* concluded that "the Code's legislative history makes clear that the Court can designate the vote of a creditor who has a conflict of interest with the class in which it votes," *Dune Deck*, 175 B.R. at 845, this is not a view that has been universally shared by the courts – as reflected in the case law dealing with crossover voting. The broader revision of section 1126(e) set forth below is designed to make clear that a creditor's (or equity holder's) conflict of interest with the class in which it votes would, in certain circumstances at least, constitute a basis for vote designation:

> (e) On request of a party in interest, and after notice and a hearing, the court may: (i) designate any entity whose acceptance or

> rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title; or (ii) designate for any class of claims or interests any entity that has, with respect to such class, a conflict of interest that is of such nature as would justify exclusion of such entity's claim or interest from the amounts and number specified in subsections (c) and (d) of this section.

A comparison of this rewrite to the current version of section 1126(e) follows:

> (e) On request of a party in interest, and after notice and a hearing, the court may: (i) designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title; or (ii) designate for any class of claims or interests any entity that has, with respect to such class, a conflict of interest that is of such nature as would justify exclusion of such entity's claim or interest from the amounts and number specified in subsections (c) and (d) of this section.

Conference Position: The Conference supports Alternative No. 1. Alternative 1 provides greater guidance than Alternative No. 2, which is too broad. Moreover, Alternative No. 1 ensures that, in a situation involving crossover voting, the creditor or interest holder in question could at least vote its claims or interests in the class in which it has the predominate economic interest.

2. Reporting Holdings.

As indicated above, any attempt to monitor and control crossover voting would be meaningless unless each entity voting a claim or interest is required to disclose all "disclosable economic interests" (as the term is defined in Bankruptcy Rule 2019) which it has respecting each class of claims or interests under the plan.

The Conference has considered several different alternative approaches to reporting in connection with voting. The positions may be summarized as follows:

i. Zero Mandatory Reporting. This is basically the current regime, unless a creditor is part of a collective and required to disclose its holdings under Rule 2019. The argument in favor of leaving the current regime in place is that mandatory reporting of holdings would impose unnecessary burdens and complications, and that currently-available discovery mechanisms would be sufficient for cases in which parties suspect that conflicts of interest warrant vote designation. A counter argument is that, absent mandatory reporting, attempts to obtain the information necessary to enforce a

limitation on crossover voting/conflicts of interest voting will produce discovery battles.

ii. Mandatory Reporting of Holdings Above a Certain Threshold As Part of the Voting Process. This approach would impose a new requirement that each voting holder of claims in a class whose holdings (aggregated with those of other entities who have the same decision maker, as discussed below) exceed some threshold percentage of the amount of the claims in the class (*e.g.*, 5%) must report all of its "disclosable economic interests" (as defined in current Rule 2019) on its ballot when it votes. Notice of this reporting requirement would be provided with the ballot and disclosure statement, with the goal that this reporting requirement would neither delay the voting and confirmation process, nor require a discovery battle to obtain holdings information. This approach would, however, raise confidentiality issues, *i.e.*, who would be entitled to receive this holdings information? One drawback noted in connection with this self-reporting scheme is that it imposes upon each party voting on a plan the burden of determining whether it in fact qualifies as a "large holder." However, comparable disclosure is already required by the latest versions of orders restricting trading to preserve tax net operating loss carryforwards ("NOL Orders") without triggering this concern. Notice of the required disclosure could be included in the notice of the proposed disclosure statement filed at least 25 days before the hearing on same.

iii. Mandatory Public Access to All Beneficial Holder Ballots. Under this approach, which could provide the greatest transparency, copies of beneficial holder ballots cast by the ultimate beneficial holders of claims would be publicly available for review. This would enable parties in interest to determine for themselves whether a crossover voting or conflict of interest voting problem exists, without having to rely on self-reporting by large holders, and without imposing the burden on each creditor casting a vote of determining whether it is a "larger holder."

Conference Position: The Conference supports Alternative (ii) (mandatory disclosure of holdings above a minimum threshold as part of the voting process), with the two modifications described below, and rejected Alternatives (i) and (iii). The first modification of Alternative (ii) is that the Conference supports requiring those voting creditors and interest holders whose holdings are above the threshold to disclose all of their disclosable economic interests in a court filing, rather than merely "checking a box" stating that they are above the threshold amount and forcing some other party to take further action to obtain additional information.

The second modification is that the phrase "with respect to the relevant claims against the debtor" should be added following the phrase "aggregated with those of other entities who have the same decision maker." The purpose of this additional language would be to clarify that, in order for the claims of separate entities to be aggregated for purposes of determining whether the

applicable claims threshold has been met, they must have the same decision maker for the particular claims at issue.

To implement this recommendation, Rule 3003 would be amended by the addition of a new paragraph (e) as follows:

> (e) Each voting holder of claims or interests in a class whose holdings (aggregated with those of other entities who have the same decision maker with respect to such claims or interests) equals or exceeds 5% of the claims or interests in the class, and who votes to accept or reject a plan, shall report all of its disclosable economic interests (as defined in Rule 2019) in a statement filed with the Court on or prior to the last date for accepting or rejecting the plan.

It seems more appropriate to implement a disclosure requirement through an amendment of the Rules than through amending the Bankruptcy Code.

Although disclosure of 5%-or-more holdings "on the ballot" was suggested, this is an unsatisfactory requirement, because a beneficial holder's ballot is seen only by the institution that holds of record for the beneficial holder on the books of the Depository Trust Company. While the Conference rejected public disclosure of all beneficial holder ballots in favor of self-reporting by 5%-or-more holders, the Conference did not reject public self-reporting by each 5%-or-more holder. Moreover, ballots are (to the extent possible) electronically processed, and there is no way for the form of ballot to provide an electronically processable format sufficient to cover the myriad forms of "disclosable economic interests" that may need to be disclosed. Requiring each 5%-or-more voting holder to report its holdings in a court filing allows such holder the flexibility to structure such reporting to meet its facts. As proposed, the Rule would also allow a 5%-or-more holder to avoid reporting altogether as long as it does not vote.[1]

[1] One issue of implementation raised by this recommended new Rule is how to determine whether separate entities have "the same decision maker" with respect to the claims or interests being voted. One possible approach would be to look to IRS rulings on whether funds' shareholdings should be aggregated to constitute a 5% holder in measuring whether a change in control has occurred that would limit use of tax attributes under Internal Revenue Code § 382. After reviewing materials on this matter, including COLLIER ON BANKRUPTCY TAX ¶ 11.04[4][b][iv] (C. Jenks, Ed).(Matthew Bender 2013), however, the Committee does not recommend using tax precedents for purposes of applying disclosure requirements relating to voting on a plan, because tax precedents do not seem apposite in this context.

For example, IRS Private Letter Ruling 20060503 advised that a hedge fund comprising three partnerships with 7% of an issuer's equity would not be counted as one holder, even though the partnerships moved in parallel and had the same manager, the same investment objectives and the same percentage of their assets invested in each of the securities in their portfolios. The fund manager did not aggregate the partnerships' equity securities in making investment decisions and did not invest for control – facts sufficient for the IRS to find no common control, because the IRS is focused on making sure that equity (and debt) trading does not result in trading NOLs. However, the latter facts should not be enough to excuse reporting a 5%-or-more holding under the proposed Rule change. The test for reporting aggregate holdings in the context of voting on a plan should focus

3. Voting That is Disproportionate to a Creditor's Economic Interest in Claims Within the Class.

The current structure for voting on chapter 11 plans appears to allow a creditor to vote claims in an amount that is disproportionately high when compared to the creditor's actual economic interest in, or exposure to, claims within a particular class – "magnified voting", as opposed to the "conflicted voting" discussed above. A variety of circumstances may produce this result, including hedging; the sale of non-voting participations; the sale of a claim in a manner that permits the seller to control the vote; or an agreement to sell a claim prior to the voting record date, with the sale not closing until after the record date. The result is that, while two-thirds in amount of the claims voted in a class may accept a plan, the actual economic interests in the class voted in favor of the plan may be far less than two-thirds an amount, and could conceivably fall short of a majority in amount. The issue is whether the current structure should be revamped so that, regardless of any agreements among the parties, a party cannot vote claims in an amount greater than its actual economic interest or exposure to the class.

Even if a decision is made that a party should only be able to vote the amount of a claim that corresponds to its actual economic interest in the class, however, the details of implementation could be difficult. For example, what if a creditor has given up a partial economic interest in the claim, *i.e.*, the creditor is protected from the downside, but still has the upside?

Further, as with the case of conflicted voting (and, indeed, with virtually any attempt to supervise and control voting), any mechanism to "match" economic interest and voting power would require the disclosure by individual creditors of all "disclosable economic interests" (as the term is used in amended Bankruptcy Rule 2019) in a manner far greater than anything contemplated by Rule 2019, and would involve disclosure problems relating to the voting of publicly held securities similar to those discussed in the case of crossover holdings.

One possible approach to address disproportionate voting that the Conference considered would be to further amend Section 1126(e) to authorize the court to designate all or part of a creditor's vote to the extent that creditor seeks to vote claims or interests in an amount that is disproportionately high when compared to the creditor's actual economic interest in, and exposure to, claims or interests within the particular class. This could be accomplished by deleting the word "or" before the new clause (ii) whose addition was recommended above, and adding the following new clause (iii) to the end of Section 1126(e):

> "or (iii) as to all or part of such holder's claims or interests in a class, such holder's claims or interests that have been voted to

on whether a fund manager is using conflicting positions in multiple classes to vote on a plan so as to prejudice one class and benefit the other. If a fund manager has the power to vote securities held by multiple funds, that is sufficient to require aggregation of the securities for reporting purposes under Rule 13d-3 under the Securities Exchange Act of 1934, and such power should be sufficient to cause aggregation for reporting under Section 1126 and the proposed Rule change.

> accept or reject the plan are disproportionately high when compared to the creditor's actual economic interest in, or economic risk relating to, claims or interests in such class, after considering all of such holder's disclosable economic interests in such class."

This addition would have to be accompanied by the addition of a definition of "disclosable economic interest" to the Bankruptcy Code.

Conference Position: The Conference does not support such a change and does not propose to amend the Bankruptcy Code or Rules to address this issue. Dealing with the issue of participations, where the nominal holder of a bank claim votes the whole claim even though it may hold only a fractional beneficial interest, would require forcing nominal claim holders to report participation interests (and participants to report sub-participations, etc.) "Magnified voting," while possible, has not yet manifested itself as a problem in chapter 11 practice, and would be sufficiently addressed by the reporting requirement and changes set forth above to deal with conflicted voting. The complexities of trying to deal with this issue are too great, and the issue has not manifested itself as a real-world problem in chapter 11.

4. Numerosity.

Although discussions of "blocking positions" and voting in general tend to focus on the "two-thirds in amount" requirement, numerosity is also a critical requirement that can spell the difference between class acceptance and class rejection. The current structure, however, lends itself to skewed voting and manipulation in this regard, particularly given the rise in claims trading over the last few decades. The following hypothetical will illustrate this point:

Fund Manager A and Fund Manager B each decide to buy $10 million in publicly held bonds of Company A for funds that they manage. Fund Manager A manages 20 separate funds and is required to allocate its $10 million bond purchase among the 20 individual funds. Fund Manager B, however, runs only two funds, and splits its purchased bonds between those two funds. Under the current statute, the likely result is that Fund Manager A gets 20 votes, and Fund Manager B gets 2 votes. It is hard to imagine a rationale for the numerosity requirement that justifies this result. Once again, any attempt to control this outcome would entail the imposition of disclosure requirements on voting creditors that are broader than anything in existence now.

To complicate matters further, the foregoing hypothetical assumes that the numerosity requirement is satisfied by having a majority in number of creditors vote in favor of a plan. In fact, however, the statute refers to a majority in number of "*claims*." *See In re Figter*, 118 F. 3d 640-41 (9th Cir. 1997). In situations not involving public debt, counting claims rather than creditors is at least comprehensible – the mortgagee in *Figter* who bought a claim from each of 21 creditors clearly had acquired 21 claims and was allowed to vote 21 claims for purposes of determining numerosity. It is difficult, however, to articulate a policy rationale for allowing a

single creditor to count as 21 votes for numerosity purposes, regardless of when and how the claims were acquired.

In addition, an analysis like the one in *Figter* breaks down in situations involving public debt. How many "claims" does a fund buy when it buys $10,000,000 principal amount of bonds? It is theoretically possible to take a snapshot of all holdings on the petition date and determine that Creditor A held $1,000,000, Creditor B held $2,000,000, and so on – and then decide that Creditor A holds a claim for $1,000,000 and anyone who buys from Creditor A has bought one claim for $1,000,000. Taking such a snapshot would be burdensome. Even more burdensome, and perhaps impossible, would be the task of tracing Creditor A's $1,000,000 "lot" of bonds from Creditor A on the petition date to and through subsequent brokers and purchasers. What if Fund 1 buys $300,000 of Creditor A's bonds and Fund 2 buys $700,000?

The numerosity requirement appears to be an accidental carry-over from Chapter XI, which by definition never dealt with public debt. Chapter X, which did deal with public debt, had no numerosity requirement. As shown above, a "numerosity" requirement focused on "claims" seems to make absolutely no sense when dealing with inherently divisible and tradable debt securities.

The Conference considered three ways to address this issue, not all of which are mutually exclusive:

Approach 1: The first approach would continue to use "claims" as the predicate for determining numerosity, and would amend Section 1126 to modify the numerosity requirement in the case of divisible and tradable bonds, notes and debentures, by adding a new Section 1126(h) as follows:

> (h) A note, bond, debenture or other debt security which is by its terms divisible and tradable shall be deemed to constitute that number of claims equal to the principal amount of the security divided by $1,000 and then rounded up to the nearest whole number.

Debt securities have traditionally been issued in minimum denominations of $1,000; thus, that number could be used as the divisor. This approach effectively recognizes, as did Chapter X, that numerosity is simply inappropriate when dealing with publicly traded debt by reducing it to a "majority in amount" requirement that adds nothing to the "two-thirds in amount" requirement.

Approach 2: A second approach is to change the numerosity requirement to a "one creditor one vote" construct, by changing the count from "claims" to "creditors." This would still leave us with the problems posed by the "Funds" hypothetical outlined above and similar situations involving a number of claim-holding entities under common control.

Approach 3: A third approach would be to eliminate the "numerosity" requirement altogether, as was the case under Chapter X of the former Bankruptcy Act, and as is currently the case with respect to classes of equity interests.

Conference Position: The Conference rejected Approach 3, which would eliminate the numerosity requirement, out of concern about preventing the vote of one or two large holders from overwhelming the vote of small, dispersed creditors – in effect, rendering the vote of smaller creditors meaningless.

The Conference supports Approach 2 – changing the predicate for determining numerosity from "claims" to "creditors," so that the system is "one creditor, one vote."

As to Approach 1, the Conference's position is that no distinction should be made between public debt and other classes of debt in applying the numerosity test for acceptance. Although the Conference supports the concept of Approach 1 – effectively eliminating the numerosity requirement in the context of public debt, the implementation of such a change raises a significant practical problem, *i.e.*, it is hard to see how the Code could leave in place a numerosity requirement for general unsecured claims not based on public debt, while eliminating such a requirement for public debt, unless the two types of claims always had to be classified separately. Eliminating the numerosity requirement only for public debt would have to be accompanied by the mandatory separate classification of public debt from all other debt of the same rank and priority in order for such a differentiated voting system for one group of creditors to work. Thus, for example, unsecured bond claims would always have to be classified separately from unsecured trade, tort and lease rejection claims.

Adopting the change recommended in Section 5.b *infra* to limit the unequal treatment of separately classified claims of equal rank would prevent such separate classification from becoming a vehicle for the preferential treatment of one or the other class of unsecured claims. However, mandating the separate classification of unsecured public debt from all other unsecured debt could create artificial leverage for one of the two separately classified classes of claims of equal rank and artificial impediments to plan confirmation. For example, in a case where a single class consisting of all unsecured claims would have voted to accept a plan, but the bondholders or other unsecured creditors, standing alone, voted to reject the plan, the separate classification of these two groups would increase the leverage of the dissenting group by enabling it to force a cramdown by rejecting the plan. If the proposal to change the predicate for determining numerosity from "claims" to "creditors" is adopted, any remaining benefit of eliminating the numerosity requirement for public debt seems to be outweighed by the negative substantive consequences of mandating the separate classification of unsecured public debt in every case.

* * * *

The Conference also considered a possible change in the statute to address the issues regarding the application of the numerosity requirement in the context of affiliated entities that are illustrated by the "fund manager" hypothetical on page 12, where affiliated entities under common control may arguably distort plan voting and create artificial impediments to plan confirmation by getting one vote each for numerosity purposes. That statutory change would be to treat affiliates who are under common control and are not separated by a trading "wall" as a single creditor for purposes of determining numerosity. Thus, for example, notwithstanding the fact that Fund Manager A manages twenty separate funds and Fund Manager B manages only two funds, each set of funds would count as only one creditor in determining numerosity.

The argument in favor of such a change is that the ability of a particular fund manager or affiliated corporate group to use numerosity to block acceptance of a plan by a creditor class and force a cramdown should not turn on the number of funds that the fund manager happens to control or the number of entities in an affiliated corporate enterprise that hold claims against the debtor. It is hard to find a policy rationale that justifies allowing a fund manager who places $1,000,000 in bonds in ten funds to force a cram down of a plan that is accepted by four fund managers who hold $100 million of the same bonds in eight funds instead of eleven funds. Such a result simply makes no sense from any rational systemic standpoint.

A variety of arguments were, however, raised against this proposed change. To begin with, it violates basic notions of corporate and entity separateness. Why should entity separateness be disregarded for numerosity purposes just because the separate entities are under common control? Why is it any more rational for ten funds who collectively hold $1 million in claims to force a cram down of a plan accepted by eight funds holding $100 million in claims when the ten funds are under separate management than when they are under common management?

Moreover, the suggested change, requiring as it does inquiry into issues of common management, ethical walls and trading practices, could provide a platform (or excuse) for intrusive discovery (and discovery battles), not only in the case of multiple funds managed by a single fund manager, but also in the case of multi-entity corporate structures. The opponents of the proposed change do not believe that the problem that it seeks to solve is sufficiently significant or prevalent to justify opening the door to this type of potentially abusive discovery.

Finally, while similar arguments might be proffered against the "aggregation" provision for determining whether the 5% "threshold" for certain disclosures has been met in the context of plan voting (*see* p. 8, *supra*), the situations are different: the "aggregation" concept, as applied in the disclosure context, would not have any substantive consequences or limit voting rights or the effect of a creditor's vote. In contrast, treating separate entities as a single creditor for numerosity purposes clearly would have a substantive effect on the weight accorded to certain votes.

Conference Position: On balance, using common control to determine numerosity when dealing with affiliated creditors raises more questions than it answers, and should not be implemented.

To implement the Conference's recommendations regarding numerosity, Section 1126 (c) would be rewritten to read as follows:

> (c) A class of creditors has accepted a plan if the plan has been accepted by (i) creditors in such class comprising a majority of all creditors in such class who have accepted or rejected such plan and (ii) holders of allowed claims of such class comprising two-thirds in amount of all allowed claims of such class whose holders have accepted or rejected such plan. If a creditor's acceptance or rejection has been designated under subsection (e) of this section, the creditor and the creditor's acceptance or rejection shall not be counted in determining the number of creditors or amount of claims in such class that accepted or rejected the plan.

5. Classification.

a. Voting Issues

Classification may impact voting results because the definition of what claims are included within, or excluded from, a class may determine whether the requisite voting majorities are obtained within the class. For example, in single asset real estate cases, splitting the class of unsecured claims between the deficiency claim of the secured lender and the claims of trade creditors has been used to try to circumvent the "one impaired consenting creditor class" requirement of Section 1129(a)(10) of the Code. Courts have, however, dealt with this issue, and we see no need for revising the Bankruptcy Code to address it.

Theoretically, classification could also serve as a mechanism for attempting to deal with conflicts of interest within a class. For example, creditors holding claims of a particular type that would ordinarily be classified in the same class (call it "Class A") but who have claims in conflicting classes, might be separately classified from the conflict-free Class A creditors, instead of having their claims classified in Class A, but designating their votes. Such a classification scheme could, however, produce the perverse result of allowing the conflicted Class A creditors to obtain a better distribution on the relevant claims than the conflict-free Class A creditors. This is because, if left in Class A, the conflicted creditors might be outvoted by the non-conflicted creditors, with the result that the conflicted creditors would not be entitled to the protection of the "fair and equitable" and "not discriminate unfairly" requirements with respect to their Class A claims. On the other hand, if the conflicted Class A creditors had their own, smaller, separate class, they could reject the plan, thereby becoming entitled to enhanced "fair and equitable" and "non-discriminatory" treatment for what would otherwise have been Class A claims.

Conference Position: The subclassification of claims should not be used as a means to deal with the issue of "crossover" holdings. Vote designation seems a "cleaner" way than the proliferation of subclasses to deal with the issue of crossover holdings and conflicts of economic interest in a class.

b. Treatment Issues

Section 1122(a) of the Bankruptcy Code provides that, except as provided in Section 1122(b) (which permits the creation of an "administrative convenience" class), "a plan may place a claim on interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." Although Section 1122(a) thus specifically requires that all claims within a class be "substantially similar," it does not require that all "substantially similar" claims be placed in the same class. As a result, the case law generally has read Section 1122(a) to permit a plan proponent to classify "substantially similar" claims in different classes, thereby giving plan proponents some leeway in the classification of claims.

The problem with this construct is that, in combination with the provisions of chapter 11 of the Code that govern the treatment of claims in comparison to one another, this leeway also enables plan proponents to circumvent the fundamental bankruptcy policy of equality of distribution among creditors of equal priority through the separate classification of claims of equal rank. This result flows from the fact that although a plan must adhere to the "equality" principle as to "substantially similar" claims which are placed in the same class, it need not do so with respect to "substantially similar" claims that are placed in different classes.

Section 1123(a)(4) of the Bankruptcy Code requires that a plan "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to less favorable treatment of such particular claim or interest." Thus, for example, if claims of unsecured bondholders and claims of other unsecured creditors are classified in the same class, a dissenting bondholder cannot be forced to accept "less favorable treatment" than the holder of another general unsecured claim.

The result is different, however, if claims of equal rank — for example, unsecured bond claims and other general unsecured claims – are classified in separate classes. If the plan treats the class of other unsecured claims more favorably than the class of bond claims, and the class of bond claims accepts the plan by the requisite majority in number and amount, there is no restriction on the degree to which the plan can discriminate in favor of other general unsecured claims and against bond claims, other than whatever protection might be provided to the dissenting bondholder under the "best interests" test. Even if the separate unsecured bond class rejects a plan that offers the other general unsecured claims more favorable treatment than the unsecured bond claims, that plan can still be confirmed if it "does not discriminate unfairly" and is "fair and equitable" with respect to the dissenting bond class.

The "not discriminate unfairly" standard certainly leaves room for the disparate treatment of classes and creditors of equal rank and priority.[2] For example, under one accepted formulation of the standard for determining whether "unfair" discrimination exists, no justification for the discrimination need even be shown unless a difference in the plan's treatment of two classes of equal priority results in either a "materially" lower percentage recovery for the dissenting class, or an allocation under the plan of "materially" greater risk to the dissenting class in connection with its proposed distribution. Either way, a test based on "materiality" offers considerable room for debate and fosters litigation and the disparate treatment of classes of equal rank, contrary to the fundamental bankruptcy principal of equality of distribution.

It is highly questionable whether Congress ever intended to allow a plan proponent to circumvent the "same treatment" requirement applicable to claims of equal rank which are classified in the same class, by permitting the plan proponent to separately classify claims of equal rank and thereby bring itself within a looser "not discriminate unfairly" standard. First, the provision in Section 1122(b) of the Code that specifically permits the creation of a separate "administrative convenience" class would seem to have been unnecessary if Congress contemplated that a plan proponent would in any event have discretion to place "substantially similar" claims in different classes. Moreover, a fact that is generally overlooked in the debate over the separate classification and disparate treatment of claims of equal rank is that the legislative history of the requirement that a plan "not discriminate unfairly" discusses that requirement ***only*** in the context of the proper application of contractual subordination where there are two classes of equal rank compared to one another, but of unequal rank compared to a third class. In particular, the only context in which the legislative history discusses the requirement that a plan "not discriminate unfairly" is one involving the following three classes: (1) trade claims (that are neither contractually senior nor contractually subordinated); (2) contractually subordinated claims; and (3) contractually senior claims. If Congress had actually contemplated that creditors who were of equal rank and priority in all respects (compared both to one another and to other creditors) could nevertheless be separately classified and treated unequally, and that their comparative treatment would be governed by a "not discriminate unfairly" standard that was looser than the "same treatment" requirement and hinged on the "materially" of the disparity, one would have expected the legislative history to have said ***something*** about such a scenario. Nevertheless, while describing in detail the application of the "not discriminate unfairly" test in the context of contractual subordination, the legislative history says nothing about the application of such a test to permit the disparate treatment of creditors of equal rank that have been placed in separate classes, or how to go about applying the test in such a scenario – an omission which at least suggests that Congress never anticipated that such a scenario would arise in the first place.

[2] The potentially standardless flexibility of the "not discriminate unfairly" standard was graphically illustrated in *In re City of Detroit*, 524 B.R. 147, 253-56 (Bankr. E.D. Mich. 2014), where the recoveries for the dissenting creditor classes were 13% and 25%, and the court held that even if the unsecured classes of pension claims received 59-60% of their claims, the discrimination was not "unfair," noting that "the factors that inform this judgment of conscience also naturally, and equally importantly, include the court's experience and sense of morality."

In any event, the current statutory construct appears to give plan proponents too much latitude, and to create too much room for unnecessary litigation, with respect to the uses of separate classification to impose disparate treatment on creditors of equal rank.

Conference Position: The Conference supports the view that discrimination between essentially equal creditors is a real problem under the current statute that should be addressed. However, the Conferences does not support addressing the problem by requiring that substantially similar claims always be classified in the same class Instead, the Conference supports strengthening the principle of "equal treatment for equal claims" by adding a sentence to the end of Section 1129(b)(1) as follows:

> A plan discriminates unfairly against a dissenting class if distributions on account of claims against the debtor in such dissenting class do not have a value, expressed as a percentage of the claims in such dissenting class, that is substantially similar to that of distributions on account of claims in a class of equal rank against the debtor, also expressed as a percentage of the claims in such class of equal rank, before taking into account any distributions which such dissenting class and such other class of equal rank may receive as a result of a subordination agreement to which claims in another class are subject. [3]

The phrase "before taking into account any distributions which such dissenting class and such other class of equal rank may receive as a result of a subordination agreement to which claims in another class are subject" requires some elaboration. Without that language, a plan could permissibly provide the same percentage recovery to classes of unsecured creditors which are of equal rank as to one another, but only one of which is entitled to treatment as "senior debt" under

[3] The Committee has not discussed the appropriate treatment of subordinated claims. Subordinated claims are, by contract, equity or law, payable only after senior claims are paid in full. Since *Northern Pacific Rwy. Co. v. Boyd*, 228 U.S. 482, 508 (1913), the "fair and equitable" rule has meant that senior claims (in that case, secured claims) could not forgo full payment in order to provide value to a junior class (equity) while leaving a middle class (trade claims) unpaid. The joint statements of Representative Edwards and Senator DeConcini, which were the equivalent of a conference report on the Bankruptcy Code, incorporated "no class skipping" into the fair and equitable rule: "Contrary to the example contained in the Senate report, a senior class will not be able to give up value to a junior class over the dissent of an intervening class unless the intervening class receives the full amount, as opposed to value, of its claims or interests." 124 Cong. Rec. H 11,103 (Sept. 28, 1978); S 17,320 (Oct. 7, 1978). A comparison of the joint statements to the rejected provision in the Senate Bill indicates that preclusion of class-skipping was intended to apply (and protect) subordinated debt. *See* S. Rep. 989, 95th Cong. 2nd Sess. 127-28 (1978). However, Section 1129(b)(1)'s invocation of the "fair and equitable" rule commences with "Notwithstanding Section 510(a) of this title", which, to say the least, is opaque. Moreover, plans have occasionally violated (or attempted to violate) the prohibition against class skipping by classifying senior and subordinated debt in the same class and implementing the subordination agreement within the class under Section 1123(a)(4). In the future the Committee should consider, whether subordinated debt should retain the right to preclude distributions to junior classes even when such distributions are out of the pocket of senior claimants. If subordinated debt does have such a right, then the Code should be amended, first, to clearly preclude classification of subordinated debt in the same class as senior debt, and second, to clearly prohibit class skipping.

a subordination agreement to which a third class of claims is subject. The additional language is designed to prohibit such a result.

The following example illustrates the application of the "before taking into account" provision: Unsecured claims against the debtor include $100,000 of debts to suppliers of goods and services ("trade debt"); $200,000 of debt to banks for borrowed money ("bank debt") and $100,000 of debentures that are contractually subordinated to the bank debt (as debt for borrowed money), but not to the trade debt (the "subordinated dentures"). A total of $60,000 is available for distribution to the three classes of unsecured claims under the plan. If the plan provided for the distribution of $20,000 of that amount to the trade debt and $40,000 to the bank debt, and was rejected by the class of bank debt, the holders of bank debt could not challenge this distribution scheme as it violating the "not discriminate unfairly" requirement in the absence of the "before taking into account" language, because the 20% distribution to claims in the dissenting class of bank debt would be "substantially similar" – in fact the same – as the 20% distribution to the trade debt.

The "before taking into account" language requires a comparison of the distribution that each class is receiving directly from the estate, before taking into account any turnover from third parties under a subordination agreement. In the above example, a ratable distribution of the $60,000 available to unsecured creditors to the three classes, before taking into account any subordination provision, would result in a distribution of $15,000 to the trade debt; $30,000 to the bank debt; and $15,000 to the subordinated debentures. Because the holders of bank debt are entitled to a turnover of the $15,000 to which the subordinated debentures would otherwise be entitled, $15,000 of the distribution to the bank debt represents a distribution "which such dissenting class [the bank debt] . . . may receive as a result of a subordination agreement." Thus, in a hypothetical plan under which holders of bank debt receive $40,000, only $25,000 ($40,000 minus $15,000 in turnover from subordinated debentures) would be considered for purposes of applying the "not discriminate unfairly requirement" to the bank debt "before taking into account" the turnover distribution. Under this hypothetical plan, the trade debt would be deemed to receive a 20% distribution ($20,000 on account of $100,000) and the bank debt would be deemed to receive a 12.5% distribution ($25,000 on account of $200,000) when the computation is performed "before taking into account. . ." Because these two percentages are not "substantially similar," the plan would fail the "not discriminate unfairly" test. In order to satisfy this test if the bank debt class rejected the plan, the plan would have to provide $45,000 to the bank debt ($30,000 as its pro rata share of the $60,000, plus a turnover of the $15,000 share otherwise allocable to the subordinated debentures) and $15,000 to the trade debt (while still giving nothing to the holders of subordinated debt).

Corporate Groups

Thursday, May 28, 2015
2:50 p.m.-3:50 p.m.

Marcia L. Goldstein
Todd F. Maynes
Hon. Brendan L. Shannon

October 30, 2014

Committee to Rethink Chapter 11

Basic Principles Governing the Reorganization of Corporate Groups

In this memo, we map out a general approach to the problem of corporate groups in bankruptcy. We offer some specific examples, but at this point they should be regarded as illustrations rather than individual ideas that require an up-or-down vote. Especially because there is considerable division within the committee about exactly where various lines should be drawn, we are more concerned at this point with forging a consensus on basic principles than debating specific detail.

Our starting premise is that the Bankruptcy Code needs to account for the organization of the modern large business enterprise. Large businesses today typically consist of a corporate group. In contrast to the conglomerates of the 1960s, these corporate groups are not an assortment of firms doing business in their own silos. The entire group is centrally managed. The cash flows through a single account. One subsidiary is responsible for paying all the invoices. Another holds all the intellectual property licenses for the entire group. Some creditors lend to the parent corporation, while others lend to the various subsidiaries.

Common justifications of bankruptcy focus on the business enterprise as a whole, but the Bankruptcy Code as written focuses on legal entities. The Bankruptcy Code treats each legal entity in a corporate group as a separate debtor. Bankruptcy Rule 1015(b) does allow for the joint administration of the different entities, but the Bankruptcy Code fails to focus on the need to preserve the value of the corporate enterprise as a whole. In principle, creditors of a subsidiary entity can demand a course of action that, while value-maximizing for that legal entity, is ruinous to the enterprise as a whole.

The committee believes that Chapter 11 should facilitate the reorganization of the business enterprise as a whole, even when the operations are divided among multiple corporate entities. There is an important type of business that falls between the real estate magnate who puts each project in a separate silo and one whose operations are so muddled that substantive consolidation is appropriate. The Code should recognize this category explicitly. The changes that are made to Chapter 11 should take account of three central principles:

1. The debtor should be able to make an initial showing that a corporate group (or part of a corporate group) operates as a single economic enterprise. Once

this showing is made, the debtor should be able to continue to operate as a single entity. In large multi-debtor Chapter 11 cases, debtors almost always file a first-day motion seeking to continue to use their centralized cash management systems, honor prepetition obligations relating to the cash management systems, maintain existing business forms, and maintain existing bank accounts. One set of professionals represents the corporate group as a whole, and conflicts or special counsel are appointed as necessary for any issues as to which the corporate group has a conflict with a specific debtor. This reform would explicitly recognize that such practices are appropriate. The United States Trustee should not be able to demand a separate §341 hearing for each entity in a corporate group. Many other reforms would be largely procedural. To the extent that the enterprise keeps records on a consolidated basis, it can continue to do so. The burden would be on an objecting party in interest to show that departing from these practices was necessary to protect substantive rights. To the greatest extent possible, the foregoing reforms should be implemented through changes to the Bankruptcy Rules rather than the Bankruptcy Code. Consistent with the idea that a single business is involved, some substantive principles would apply differently. We start to identify some of these below.

2. The structural priority of creditors should be respected as long as there is no basis for nonconsensual substantive consolidation. Unless the plan proponent can show that corporate form has been disregarded or the cost of sorting out the intercorporate transfers is prohibitive, creditors of a subsidiary entity should have priority to the value of any assets of the subsidiary.

3. To resolve the tension between these two competing principles, creditors of specific entities should be able to appear and invoke a new set of protections. Just as secured creditors can insist upon adequate protection, creditors of a subsidiary entity should be able to invoke procedures that protect their rights as well. As we suggest later in this memorandum, spelling out exactly what form this protection should take is not easy. A way needs to be found that protects substantive rights. There should not be a toothless test that allows rights to be compromised merely by invoking some magic words. At the same time, the test cannot impose undue costs on the reorganization or empower activist investors.

The rest of this memo is in three parts. The first sets out the rationale for introducing the idea of a corporate group into reorganization law. The second section sets out the need to recognize and respect structural priority. The third section

reviews some of the problems that will arise in ensuring that structural priority rights are respected while the corporate group is treated as a single enterprise.

1. The "Corporate Enterprise"

When a parent and affiliated entities file for Chapter 11 at the same time, the parent debtor should have the ability to ask that the parent and identified affiliates be treated as a single "corporate enterprise" for purposes of the reorganization. A "corporate enterprise" should be found when multiple legal entities (including both corporations and limited liability companies) act as a single economic firm. The corporate enterprise is to be distinguished from those cases in which a parent entity owns a number of discrete businesses that are both financially and operationally independent. Such cases would continue to be jointly administered, but would not be covered by the special rules for corporate enterprises.

Identifying the corporate enterprise is not always self-evident. Cases commonly exist in which a parent and some of its subsidiaries are a single business, but other subsidiaries operate in their own silos. For this reason, the debtor that wants to be treated as a corporate enterprise should be required to identify which entities constitute a single economic firm. After the debtor makes this initial identification, parties in interest would have a chance to argue that common enterprise either does not exist or is constituted differently. The court could tailor narrow relief so as to mitigate the cause without creating an undue burden on the debtors' estates.

If a party in interest seeks to separate a debtor from the corporate enterprise into its own silo, courts should apply a high standard for isolating such debtor. Under that standard, a party in interest should have to demonstrate that the separate debtor has no material interest in and derives no material benefit from the corporate enterprise. A party in interest should have to show that the separate debtor does not benefit materially from corporate enterprise efficiencies. A party in interest should not be able to separate its debtor from the rest of the corporate group if the debtor enjoys shared financing, greater buying power, or reduced employee and other costs.

Once the court finds that a corporate enterprise exists, a number of consequences follow. The debtor could continue to manage cash centrally and continue to operate the corporate enterprise as before. The debtor should be allowed to file consolidated schedules of assets and liabilities, current income and expenditures, executory contracts and expired leases, and statements of financial affairs. The debtor would not be required to file a monthly operating report for each legal entity in the absence of a showing by a party in interest that separate reporting is necessary to protect their nonbankruptcy rights.

Substantive consequences also follow from establishing a corporate enterprise. We provide several illustrations. In resolving a question such as whether the filing of a solvent subsidiary was done in good faith, the court should look broadly at the corporate enterprise as a whole, not narrowly at the subsidiary itself. This is consistent with Judge Gropper's decision in In re General Growth Properties, Inc., 409 Bankr. 43, 61 (Bankr. S.D.N.Y. 2009) (declining to examine issue of good faith as if each debtor were independent; instead, evaluating based on "interests of the Group as a whole").

The court should not be able to apply the single-asset real estate rules if the debtor can show that a corporate enterprise exists. For example, a corporate enterprise may exist when the parent company manages dozens of different apartment buildings and sweeps all the revenues into a single account. In such a case, the single-asset real estate rules should not apply, even though each of legal entities would otherwise be treated as a single-asset real estate case. This outcome is inconsistent with In re Meruelo Maddux Properties, Inc., 667 F.3d 1072 (9th Cir. 2012) (single-asset real estate measured on an entity, not corporate group basis). Similarly, creating a special purpose entity would not remove such entity from the corporate enterprise if the other attributes exist.

Similarly, the measure for whether there is an impaired class of creditors that approves a plan of reorganization should be on the corporate enterprise as a whole. It is sufficient if there is a consenting class of creditors for the group as a whole, even if a particular legal entity that is a constituent member of the corporate enterprise lacks such a consenting creditor. Bankruptcy courts are currently divided on this question under existing law. Compare JP Morgan Chase Bank v. Charter Communications Operating, LLC, 419 Bankr. 221, 250 (Bankr. S.D.N.Y. 2009), with In re Tribune Co., 464 Bankr. 126 (Bankr. Del. 2011).[1]

Other changes are possible as well. For example, it might make sense to provide a presumption that an entity within a corporate group received reasonably equivalent value when it guarantees a loan that is made to the corporate enterprise. If a corporate group enjoys synergies from the way in which all the individual entities contribute to the whole, value bestowed upon the group is likely to benefit each of its constituent parts.

Such a change, however, is more controversial. Introducing this presumption would not necessarily change the outcome of cases such as In re TOUSA, Inc., 680 F.3d 1298 (11th Cir. 2012). It is only a presumption and can be overcome. It may be

[1] This assumes that §1129(a)(10) remains a requirement for confirmation in some form.

manifest that a loan brought benefits to some of its constituent elements. Nevertheless, this change would impose a bankruptcy standard on a question that is properly a subject of nonbankruptcy law, at least to the extent that it arises through §544(b) rather than §548.

More important than any specific procedural or substantive change, however, is whether it makes sense to introduce a new concept to the law (called here the "corporate enterprise") administered by its own set of benchmarks, benchmarks geared to two principles—that bankruptcy is aimed at preserving going concerns and that the going concern in some cases consists of multiple discrete legal entities. Many bankruptcy judges implicitly accept the idea that bankruptcy should operate on the going concern, not on the discrete legal entities, but in many instances they lack explicit statutory authorization for the practices they adopt or, as in the case of §1129(a)(10), they act in a way that is in tension with the explicit language of the Code.

2. Structural Priority

As a matter of nonbankruptcy law, an unsecured creditor of a subsidiary enjoys priority over an unsecured creditor of the parent entity in the same fashion that a secured creditor of the parent entity would enjoy priority over the unsecured creditor. As with nonbankruptcy rights as a general matter, this right should be respected in bankruptcy.

When a creditor loans to a specific entity in a corporate enterprise, it does so in the expectation that, with respect to the assets of that entity, it is entitled to be paid first. Its substantive right to priority should be protected if corporate forms have been respected and if it is possible to sort out the intercorporate obligations. A sensible set of rules governing corporate enterprises should aim to protect the value of the economic firm as a whole, while at the same time respecting the substantive priority right of the creditors of each of the entities.

The substantive entitlements of creditors of a specific legal entity should be consistent with the best modern understanding of substantive consolidation. It is based on the following five principles:

1. Limiting the cross-creep of liability by respecting entity separateness is a fundamental ground rule. As a result, the general expectation of state law and of the Bankruptcy Code, and thus of commercial markets, is that courts respect entity separateness absent compelling circumstances calling equity . . . into play.

2. The harms substantive consolidation addresses are nearly always those caused by *debtors* (and entities they control) who disregard separateness. Harms caused by creditors typically are remedied by provisions found in the Bankruptcy Code.
3. Mere benefit to the administration of the case (for example, allowing a court to simplify a case by avoiding other issues or to make postpetition accounting more convenient) is hardly a harm calling substantive consolidation into play.
4. Indeed, because substantive consolidation is extreme (it may affect profoundly creditors' rights and recoveries) and imprecise, this "rough justice" remedy should be rare and, in any event, one of last resort after considering and rejecting other remedies.
5. While substantive consolidation may be used defensively to remedy the identifiable harms caused by entangled affairs, it may not be used offensively (for example, having a primary purpose to disadvantage tactically a group of creditors in the plan process or to alter creditor rights).

In re Owens Corning Corp., 419 F.3d 195, 211 (3d Cir. 2005) (internal citation omitted).

3. Protecting Structural Priority

Mediating between the need to focus on the corporate enterprise and respecting structural priority is the principal challenge we face. The mechanism we envision is the familiar one of empowering individual creditors to make objections and insist on specific protections.

Some process rights seem straightforward. Creditors of any of the various entities should be able to appear in matters about the reorganization as a whole even when the matters do not directly concern their debtor. (By the same token, an unsecured creditor of a parent holding should have similar rights. Because of its interest in the corporate enterprise as a whole, such a creditor should have a right to be heard in matters concerning the subsidiary, even if no interest of the parent is directly at stake.)

Beyond simply appearing in court and mounting objections, affected creditors should be able to have their substantive nonbankruptcy rights protected. Identifying exactly what sort of protections creditors should enjoy is harder. The extreme position would be to grant these creditors the same sort of rights—including adequate protection—that a secured creditor of a single debtor would enjoy.

The subsidiary (as opposed to a creditor of the subsidiary) can be given different forms of protection. In many cases, subsidiary net advances to its parent are granted administrative claim status. In more compelling situations, the subsidiary might be give a security interest in the net cash flows going from the subsidiary to the parent during the case. Thus, the cash management order might provide that the subsidiary has an administrative expense claim or a secured claim on account of such net cash flows. Of course, a DIP lender would likely require its lien and its administrative expense claim to be senior.

Mechanically transplanting the rights of secured creditors to others who enjoy structural priority seems a mistake, however. The rights of secured creditors and creditors with structural priority are not the same as a matter of nonbankruptcy law, and treating them the same in bankruptcy introduces significant complications. For example, when a corporate enterprise seeks DIP financing, the DIP lender will commonly insist on enjoying priority with respect to all the assets of the corporate enterprise for a loan it makes to the corporate enterprise as whole. Meeting the stringent standards of §364(d) with respect to each creditor of a corporate group may be nearly impossible. It is important to the DIP financing market that liens on available subsidiary assets can be taken if it is necessary to support the financing of the enterprise. See, e.g., In re Babcock & Wilcox Co., 250 F.3d 955, 961 (5th Cir. 2001). Moreover, it would further empower some activist investors. We should not want rules that encourage some to acquire positions in the debt of subsidiaries merely for the purpose of holding up the reorganization. Such investors already take advantage of entity separateness by moving for the dismissal of its debtor or the appointment of a trustee for its debtor.

Creditors of discrete entities should accept the bitter with the sweet. They should not be able to insist on the separateness of their own debtor and still enjoy the synergy that the corporate enterprise generates. For this reason, it may make sense to fashion an approach that takes this into account. When a creditor of a subsidiary demands that its nonbankruptcy rights be protected, the protections it receives might be benchmarked by the liquidation value of the subsidiary, rather than the value it enjoys by virtue of being part of a corporate enterprise. In this example, the protections apply to the subsidiary itself, not to the subsidiary's unsecured creditors. Outside of bankruptcy, unsecured creditors bear a number of risks, including the risk of having more secured debt layered above them (like a DIP and its attendant liens in bankruptcy). Such creditors should bear comparable risks in bankruptcy. Although their nonbankruptcy rights need to be accounted for, they should not receive greater protection in bankruptcy than outside it. (At the same time, to the extent that the rights they enjoy outside of bankruptcy are not mirrored in the DIP loan context, one has to think about substitute protections.) Similarly, the amount of process required

(including whatever valuations might be necessary) might be more modest as well. Possibly, a cost-benefit analysis from the subsidiary perspective might be more appropriate at the outset of the case. That said, it is important that the rights that can be invoked have traction commensurate with the structural priority to which the creditor is entitled.

BANKRUPTCY AND THE TRUST INDENTURE ACT

Thursday, May 28, 2015
4:10 p.m.-5:10 p.m.

Harlan Cherniak
Dennis F. Dunne
Alan W. Kornberg
Nate Van Duzer
Jane Lee Vris

MEMORANDUM

TO: NBC Committee to Rethink Chapter 11

FROM: Isaac M. Pachulski and Marshall S. Huebner

DATE: May 13, 2015

RE: A New Chapter of the Bankruptcy Code to Address the "Holdout" Problem Under Public Indentures and Loan Agreements

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The *Anglo Irish Bank*[1] decision involved a fact-specific challenge to the modification of noteholders' right to principal or interest upon the vote of a specified majority in amount of the notes issued pursuant to an indenture governed by English law. In contrast to English law, which permits such modifications by a less than unanimous vote, under the U.S. Trust Indenture Act (the "TIA"), the modification of payment terms is prohibited under most indentures (irrespective of their terms) without the unanimous consent of all holders of the securities. The application of this provision of the TIA was a central issue in two recent cases: *Marblegate Asset Management v. Education Management Corp.*, -- F. Supp. 3d --, No. 14 Civ. 8584, 2014 U.S. Dist. LEXIS 178707 (S.D.N.Y. Dec. 30, 2014), and *Meehancombs Global Opportunities Funds, L.P. v. Caesars Entertainment Corp.*, -- F. Supp. 3d --, No. 14 Civ. 7091 (SAS), 2015 U.S. Dist. LEXIS 5111 (S.D.N.Y. Jan. 15, 2015), both of which can be viewed as making out of court restructurings involving bonds covered by the TIA by a less than unanimous bondholder vote more difficult than previously thought.

Some have proposed that U.S. law should permit an indenture to provide for the modification of payment terms by a majority or supermajority vote, without the unanimous consent of those involved (to avoid the "holdout" problem). At the same time, however, the *Anglo Irish Bank* case also illustrates the risk of coercive tactics on the part of issuers where there are no statutory safeguards or limitations on the exercise of power by a majority of the noteholders. (In that case, the terms of the exchange offer included an exit consent under which those who participated in the exchange offer voted to modify the terms of the indenture so that noteholders who rejected the exchange and were "left behind" would receive the functional equivalent of a peppercorn in exchange for the cancellation of their notes.[2]) Moreover, even if U.S. law permitted public indentures to provide for modification of payment terms with less than

[1] *Assénagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp. Ltd. (Formerly Anglo Irish Bank Corporation Limited)* [2012] EWHC 2090 (Ch).

[2] In October 2010, Anglo Irish launched an exchange offer, pursuant to which subordinated noteholders were invited to exchange their bonds for new senior notes (for every €1 of subordinated notes, noteholders would receive 20 cents of new senior notes) *provided* that they also voted in favor of a resolution which, if passed by more than 75% of voting noteholders, would allow Anglo Irish to redeem all of the outstanding subordinated notes for a nominal amount (equal to €0.01 per €1,000 in principal amount). The English Chancery Court rejected this "exit consent" as coercive.

unanimous consent, this would not necessarily solve the holdout problem, as there is no guarantee that parties would actually draft non-unanimous consent provisions into new indentures. Indeed, even though syndicated credit facilities are not bound by the TIA and thus could, in theory, provide for less than unanimous consent, in practice, nearly all such facilities still require unanimity.

This memorandum proposes a different solution to the holdout problem in the case of claims for borrowed money involving a trust indenture or under a loan agreement involving multiple lenders. That solution would center on a new, streamlined procedure under a new chapter of the Bankruptcy Code that would permit a court to impose on all members of the affected creditor class a modification of payment terms that has been accepted by the requisite disinterested majority or super majority vote, without triggering the whole panoply of Bankruptcy Code provisions, requirements and limitations that typically accompany the filing of a petition under the Bankruptcy Code.

BACKGROUND

Section 316(b) of the TIA generally provides that an obligor under a qualified indenture cannot extend the maturity or alter the interest rate provided for under that indenture, absent the unanimous consent of affected bondholders. 15 U.S.C. § 77ppp(b) ("the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security . . . shall not be impaired or affected without the consent of such holder . . . ."). In the U.S., section 316(b)'s unanimity requirement governs all TIA-qualified indentures without regard to any language in the indentures contrary to or inconsistent with section 316(b), although most qualified indentures contain language that parallels the language in section 316(b). *See* George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings*, 14 Am. Bankr. Inst. L. Rev. 431 (2006). Section 316(b) was enacted during the Great Depression and as part of a package of legislation driven by then-SEC Chairman William O. Douglas (which package also included the Chandler Act amendments to the Bankruptcy Act of 1898) out of concern that the interests of minority stakeholders would be sacrificed for the "desires and conveniences of the dominant group." H.R. Rep. No. 10292, 75th Congress, Apr. 25, 1938, at 36; *see also UPIC & Co. v. Kinder-Care Learning Ctrs, Inc.*, 793 F. Supp. 448, 452 (S.D.N.Y. 1992) ("Enactment of Section 316(b) is attributable to the Securities Exchange Commission's concern about the motivation of insiders and quasi-insiders to destroy a bond issue through insider control, and the generally poor information about a prospective reorganization available to dispersed individual bondholders."). While successful in shielding the minority from majority abuse, the unanimity required under the TIA and most U.S. syndicated loan agreements impedes beneficial out of court restructurings.

Without the ability to bind dissenting parties — who may choose to hold out to gain negotiating leverage or simply to free-ride off the concessions of others — many distressed companies must turn to a filing under chapter 11 of the Bankruptcy Code to effectuate purely financial restructurings. Although a chapter 11 filing, or the threat of chapter 11, can be used to restructure bond debt over the objections of minority debtholders, a chapter 11 filing is a blunt and imperfect tool in this context. The debtors are required to incur considerable expense, and, potentially, business disruption in adhering to various administrative requirements, complying

with court approval obligations for many transactions and funding a creditors committee. Indeed, the debtor must prepare and file motions for any first-day relief that would be necessary on or soon after the petition date, seek approval of all non-ordinary course transactions during the pendency of the case, prepare a plan and disclosure statement and participate in the proceedings necessary to obtain approval of the disclosure statement and confirmation of a plan. Studies show that it is not unusual for the cost of larger chapter 11 cases to exceed 2% of the debtor's assets.[3] Even a prepackaged bankruptcy, where the court proceeding can be as short as 30 days, comes with considerable cost.[4] Moreover, because a chapter 11 filing may trigger *ipso facto* clauses that are enforceable in the case of certain types of executory contracts (*see* 11 U.S.C. § 365(e)(2)) and securities contracts, forward contracts, commodities contracts, repurchase agreements and swap agreements (*see* 11 U.S.C. §§ 555-56, 559-60), a chapter 11 filing necessitated solely by a holdout problem can inflict serious "collateral damage" on a debtor. Where disinterested financial creditors are the only affected creditors and a supermajority of them can agree to the terms of a restructuring of their obligations, a chapter 11 filing, in any form, may be inefficient and unnecessarily risky. A streamlined court-sanctioned process can provide a far less burdensome alternative that remains consistent with the purpose of the TIA.

The SEC report that served as the basis for the TIA focuses heavily on the need to protect minority stakeholders, but does not suggest an absolute bar on binding holdouts in a negotiated arm's-length workout. SEC Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, June 18, 1936 at 63 ("some coercion may have to be exerted upon minorities" in order to affect workouts). The concern addressed by the TIA is where "the power to coerce should rest, *unchecked*, in the hands of the majority." *Id.* (emphasis added). To prevent abuse, the TIA offers minority stakeholders that are bound to workouts an avenue to judicial review, and the legislative history of the TIA makes plain that "[e]vasion of judicial scrutiny of debt-readjustment plans is prevented" by the statute. H.R. Rep. No. 10292, 75th Congress, Apr. 25, 1938, at 35.

Indeed, appellate courts have allowed a majority of lenders to alter the payment terms of debt instruments over minority objections, even when such documents apparently contained unanimous consent provisions, in instances where the court below approved the substantive fairness of such alteration/settlement. *See, e.g.*, *Beal Sav. Bank v. Sommer*, 8 N.Y.3d

[3] *See* Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Empirical L. Stud. 111, 140 (2004) (finding that, "for a group of 48 firms with assets ranging from about $65 million to $7.5 billion, and averaging $881 million . . . firms expended, on average, 2.2 percent of assets on professional fees (1.9 percent after the removal of a single outlier)" but cautioning that "[p]rofessional fees and expenses are almost certainly subject to a scale effect."); Stephen J. Lubben, *What We "Know" About Chapter 11 Cost Is Wrong*, 17 Fordham J. Corp. &. Fin. L. 141, 166-67 (2012) (finding that fees in the largest quartile of cases studied were approximately 2% of the size of the debtor, and noting that "[t]he relationship between size and standardized cost demonstrates a strong downward trend.").

[4] Although prepackaged bankruptcies are certainly shorter than more traditional proceedings, they are not necessarily cheaper, as debtors must incur considerable expense preparing the prepackaged case prior to the petition date. 17 Fordham J. Corp. &. Fin. L. at 178 ("[P]repackaged cases do not appear to be any cheaper than traditional chapter 11 cases, once we account for at least some of the cases' pre-bankruptcy costs . . . . Prepackaged cases are only "cheaper" chapter 11 cases in the sense that the fees recorded after the petition is filed are lower.").

318, 330-31 (2007) (upholding a settlement altering financial terms because "[unanimity] provisions concerning amendment, modification and waiver of . . . agreements [did] not preclude the Administrative Agent and 95.5% of the Lenders from" reaching a post-default settlement binding on all lenders); *In re Delta Air Lines*, Inc. 370 B.R. 537, 549 (Bankr. S.D.N.Y. 2007) ("In default situations where contractual rights are already impaired by exogenous events, non-impairment clauses are moot and the Trustee's power to sue and settle subject to direction by a majority in amount or a specified minimum percentage will be sustained over the objection of a minority or individual.") (collecting cases), *aff'd* 309 Fed. Appx. 455 (2d Cir. 2009); *see also In re Residential Capital, LLC*, 497 B.R. 720, 748 (Bankr. S.D.N.Y. 2013) (approving, in the absence of investor consent, a settlement with the insurer involving commutation of rights under insurance policies and noting that "Section 316(b) [of the TIA]'s restrictions on majority action are inapplicable in insolvency proceedings"). While a review in the context of a chapter 11 proceeding—as in *Beal Savings* and *Delta*—is certainly sufficient to provide the judicial oversight envisioned by the TIA, it is not necessary.[5]

Other countries have developed specialized procedures that allow debtors to restructure bank or bond debt with judicial oversight without having to initiate broader insolvency proceedings:

- In England and Wales, a company or any of its creditors may institute a scheme of arrangement pursuant to the Companies Act 2006. A scheme of arrangement is not an insolvency procedure and does not include a moratorium on creditor action. Schemes of arrangement are binding on all members of each class of creditors and shareholders able to vote on the scheme, provided (i) the approval of the relevant majority[6] of each class is obtained and (ii) the scheme is sanctioned by the court. The scheme is subject to court review and approval and will be approved if it is fair, reasonable and represents a genuine attempt to reach agreement between a company and its creditors. The question for the reviewing court is not whether the scheme itself is reasonable but whether a creditor could reasonably have approved it. Schemes of arrangement have proven popular with English companies[7] as well as certain non-English companies[8] with the requisite connection to the U.K.

[5] *See* James E. Spiotto, *Defaulted Securities: The Prudential Indenture Trustee's Guide* (1990), at XIX-20 (Section 316(b) "does not (and cannot be read to) bar a settlement on how debt owed pursuant to an indenture will be paid" and "should not be read to 'hold up' the rights of the majority" so long as minority interests are adequately represented and the resolution is subject to judicial review.).

[6] If a simple majority in number of those voting in person or by proxy and a three-quarters majority in value is obtained at any meeting, a further application is made to the court for an order sanctioning the compromise or arrangement.

[7] Adam Gallagher and Victoria Cromwell, *European Update: English Schemes of Arrangement: A Tool for European Restructuring*, 31-8 ABIJ 38 (Sept. 2012) ("The ability to cram down dissenting (and even secured) creditors has made schemes particularly attractive.").

[8] *See, e.g.*, *Re Magyar Telecom B.V.* [2013] EWHC 3800 (Ch) (Netherlands); *Re Rodenstock GmbH* [2011] EWHC 1104 (Ch) (Germany); *Primacom Holding GmbH and others v. Credit Agricole and others* [2011] EWHC 3746 (Ch) (Germany); *In re La Seda de Barcelona SA* [2010] EWHC 1364 (Ch) (Spain).

- Spain's "cram down" procedure came into force on March 9, 2014 pursuant to Real Decreto-ley 4/2014, de 7 de marzo, por el que se adoptan medidas urgentes en material de refinanciación y reestructuración de deuda empresarial ("Royal Decree-Law 4/2014"). Among other things, Spain's procedures allow a company to cram down a debt modification that (i) extends the term of the debt for up to five years or (ii) converts debt into profit participating loans with a term of no more than five years, so long as it obtains the consent of creditors representing at least 60% of the total outstanding debt. If the scheme is supported by creditors representing at least 75% of the total outstanding debt, then the scheme may cram down a modification that (i) extends the term of the debt for up to ten years, (ii) converts debt into profit participating loans with a term of no more than ten years, (iii) reduces the amount owed, (iv) capitalizes debt (although dissenting lenders may opt for a write off instead of such capitalization), (v) provides for payment in kind, or (vi) converts debt into convertible notes, subordinated debt, PIK interest loans or any other financial instrument with tenor, ranking or other features different from the original debt.[9]

- The Netherlands is considering creating a similar scheme to England's scheme of arrangement.[10]

Moreover, many jurisdictions allow principal and interest terms to be modified without any court oversight, if permitted by the loan documents:

- Without an equivalent of section 316(b) of the TIA, Germany, France, Italy, Spain, England and the Netherlands all permit indentures to provide that a majority or supermajority of debtholders may modify the payment terms for all (including dissenting) debtholders. The debtholders' freedom of contract is generally respected[11] without court review, although courts might not enforce revised financial terms in subsequent proceedings if the amendment process is deemed to be oppressive or an abuse of the power of the majority to bind the minority.[12]

[9] *See* Hogan Lovells, *Royal Decree-Law 4/2014, of 7 March 2014, on Urgent Matters in Relation to Refinancing Agreements and Debt Restructuring*, available at http://www.hoganlovells.com/files/Publication/ 0e3ca987-166b-41da-8775 3b0beb3c8ced/Presentation/ PublicationAttachment/9178befe-4b40-41ca-9dc0 401a94af4eef/Hogan%20Lovells%20 %20RDL% 20March%202014.pdf.

[10] *See* Linklaters, *Banking Update: The Preliminary Draft for a New Dutch Insolvency Act: Old Ideas Parading as New Ones?*, Feb. 2, 2009, available at http://www.linklaters.com/Publications/ Publication2051Newsletter/PublicationIssue20090202/Pages/PublicationIssueItem3926.aspx.

[11] Freedom of contract is a fundamental principle of English law, such that English courts often function to enforce consensual bargains. *See, e.g. Printing and Numerical Registering Co. v. Sampson* (1875) L.R. 19 Eq 462 ("if there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered into freely and voluntarily shall be held sacred and shall be enforced by courts of justice.").

[12] *See, e.g. Anglo Irish Bank, supra* note 2.

- Certain South American jurisdictions have similar rules. In Peru and Brazil, for instance, an indenture may provide that a majority (or supermajority) of debtholders can agree to modify the principal and interest terms of the indenture and bind any dissenting holders.[13] Likewise, in Chile, if the indenture is silent, any change to the payment provisions of an indenture requires unanimous approval, but the indenture may be drafted to allow for modification of such terms with a supermajority of holders of 75% or more.[14]

A new chapter of the Bankruptcy Code, with the provisions outlined below, would be consistent with the spirit of the TIA and current U.S. jurisprudence, and build upon the progress of several other developed countries.

THE PROPOSED NEW CHAPTER OF THE BANKRUPTCY CODE.

The basic elements of the proposal are as follows:

1. A new chapter of the Bankruptcy Code will provide for a new type of summary proceeding that could be instituted: (i) only by the debtor and (ii) only for the limited purpose of modifying the rights of one or more classes of claims for borrowed money under an indenture or a loan agreement.

2. The filing of a case under this new chapter would trigger virtually none of the provisions, requirements or prohibitions ordinarily triggered by the filing of a case under the Bankruptcy Code. Thus, for example:

(a) There would be no "estate."

(b) There would be no automatic stay.

(c) There would be no avoiding powers. However, the running of the applicable reach-back periods under sections 544, 545, 547 548, and 553 of the Bankruptcy Code would be tolled during the pendency of this proceeding.

(d) During the pendency of the case, the debtor would not be subject to any restrictions that would not apply in the absence of a bankruptcy filing. There would be no restriction on the payment of prepetition debt. The debtor would not require court approval for any transaction including, for example, the sale, use or lease of property outside the ordinary course of business, debt incurrence or the settlement of a dispute.

(e) There would be no provision for the appointment of a creditors or equity committee; no provision for the appointment of an examiner; and no provision for the appointment of a trustee.

[13] Ley General de Sociedades [General Law of Corporations], art. 323, (Peru) available at http://www.congreso.gob.pe/ntley/Imagenes/Leyes/26887.pdf.

[14] Ley 18.045 de Mercado de Valores, Diario Oficial, Oct. 22, 1981, as amended March 19, 1994, *available at* https://www.svs.cl/sitio/english/legislacion_normativa/marco_legal/ley18045_ingles_07122011.pdf.

3. *Ipso facto* clauses triggered by the filing of this new type of proceeding would be unenforceable — without exception. There would be no exception to this absolute prohibition on the enforceability of *ipso facto* clauses for "safe harbored" contracts like swap and repurchase agreements; nor for contracts of the type described in Section 365(c) of the Bankruptcy Code; nor for any other contract or right, whether or not executory (to negate the *American Airlines*[15] ruling). The fact that the debtor has asked a court to make a debt restructuring binding on the dissenters within an accepting class should not, by itself, be permitted to trigger defaults and forfeitures. Because this proceeding would not trigger any automatic stay, parties could exercise all of their rights in the event of any other type of default, *provided* that any involuntary chapter 7 or chapter 11 petition filed after the filing of a case under this new chapter would be held in abeyance until the earliest to occur of: (i) confirmation of a plan; (ii) the dismissal of the case; and (iii) the 90th day following the filing of the petition (or such later date as the court may fix for cause). In addition, a "change in control" provision triggered by a change in control resulting from the provisions of a confirmed plan would be unenforceable.

4. The petition would have to be accompanied by the filing of the plan[16] and, if the debtor solicited consents prior to the petition date in accordance with Section 4(b)(i) below, the previously solicited acceptances upon which the debtor intends to rely to obtain confirmation of the plan. Only the debtor could propose a plan. In order to approve the proposed modification, the bankruptcy court would have to make the following findings:

(a) A super majority (either two thirds or seventy five percent) in amount of all claims in the class (whether or not voted) accepted the plan. (There would be no numerosity requirement.) Consent must be affirmative; an abstention would be the functional equivalent of a "no" vote. However, for purposes of tabulating the vote, debt held by the following parties would be disregarded and will not be treated as part of the claims in the class (*i.e.,* will be excluded from the denominator of the voting fraction as well as the numerator) in determining whether the requisite majority has accepted the plan: (i) debt held by the issuer or any affiliate or insider of the issuer; and (ii) debt held by parties who were found to have disqualifying conflicts of interest, akin to those that would result in vote disqualification under the modified version of section 1126(e) proposed in the Mayer/Pachulski Memo on Classification and Voting as finally approved by the Conference. Moreover, notwithstanding Section 510(a) of the Code or any provision in any contract or applicable law, and except as otherwise provided in the last sentence of this subparagraph, only the registered or beneficial holder of a claim in a class that is impaired under the plan could vote that claim. Thus, provisions in intercreditor agreements that purport to give "senior" creditors the power to vote the claims of "junior" creditors would be nullified for purposes of the plan vote.[17] *Provided, however,* that the foregoing nullification and

[15] *In re AMR Corp.*, 730 F.3d 88 (2d Cir. 2013).

[16] The new chapter of the Bankruptcy Code would contemplate a "plan" that is far more limited than plans in a chapter 11 context.

[17] The rationale for this element of the proposal is that the basic premise underlying the weight given to the supermajority vote is that dissenters are being bound by the vote of other members of the same class who share their economic interest in maximizing the recovery of that class. This rationale breaks down when the majority of the claims are voted, not by holders of claims in the class that would be bound by the vote, but by a creditor or creditors in some other class whose interests are adverse to those of the creditors who will be bound by the vote.

unenforceability of voting provisions in intercreditor agreements will not apply to the vote of any class if: (A)(i) the class does not consist of claims arising under publicly issued debt and (ii) all holders of claims in the class have ceded their right to vote their claims pursuant to an intercreditor agreement or (B)(i) holders of claims in the class have ceded their right to vote to insurers of such claims and (ii) such insurers are the economic stakeholder with respect to such claims.

(b) the solicitation of consents either: (i) if accomplished prior to the petition date, complied with applicable non-bankruptcy law; or (ii) if accomplished subsequent to the petition date, included the provision to each creditor in the impaired class, along with the ballot, of a disclosure statement approved by the court as complying with Section 1125 following a disclosure statement hearing. Thus, if the debtor chose the second option, there would be both a hearing to approve the disclosure statement (followed by a vote on the plan), and a hearing on confirmation of the plan.

(c) the plan offers and provides the same treatment in all respects to all creditors in the class, whether they accepted or rejected the plan, unless a creditor agrees to less favorable treatment. No payment by the debtor to any creditor in the class could be made outside the plan. Thus, a consent fee or the like could not be paid only to those who accepted the proposal, and no member of the class could receive any special consideration in exchange for its vote. Further, no fee or other compensation shall be paid in connection with any "Exit Financing" to any holder of claims in an impaired class unless the opportunity to participate, and obtain such fee or other compensation, is offered to every "Qualified Holder" in such class on a basis proportionate to its claims relative to the claims of all Qualified Holders in such class. "Exit Financing" means any loan, any purchase of notes, stock or other property, or any other financing contemplated by the Chapter 16 plan. A "Qualified Holder" is a person who is qualified to participate in such exit financing under applicable nonbankruptcy law. Moreover, no other consideration could be provided to any member of the class, directly or indirectly, that was not offered to all members of the class; provided, however, that the debtor's pre-petition or post-petition payment of the professional fees incurred by a creditor or group of creditors in connection with the negotiation and documentation of the plan would not constitute grounds for denying confirmation, so long as the court found that the creditor or group of creditors had played a material role in the negotiation and documentation of the plan. A finding by the court that this condition had not been satisfied would not be grounds for requiring disgorgement of any professional fees so paid by the debtor; it would simply be grounds for denying confirmation. Any such payment would have to be disclosed in the Disclosure Statement, and any party holding a claim in the same class as the recipient of the payment could object to confirmation of the Plan on the grounds that the recipient did not satisfy the "material role" requirement referred to above.

(f) The plan satisfies the "best interests" test contained in Section 1129(a)(7) as to: (i) every holder of a claim in an impaired class of unsecured claims who rejected the plan; and (ii) if the plan modifies the rights of holders of claims in a secured creditor class with respect to their collateral in a manner that could not be accomplished under the terms of the applicable contracts by the vote of those holders of claims in the class who accepted the plan, every holder of a claim in a class of secured claims who rejected the plan.

5. Notice of the hearing on confirmation of the plan and of the opportunity to object to the plan must be served on all creditors on the day the petition is filed. Creditors in the affected class would be given 25 days' notice of the deadline for objecting to confirmation of the plan. If no objection is timely filed, the court shall confirm the plan without further hearing. If an objection is filed, the hearing must be held.

6. If, at the hearing, it appears that the debtor has not obtained the requisite majority of acceptances, whether as a result of the disqualification of votes (a disqualified vote would count, in substance, as an abstention), or otherwise, confirmation would be denied and the case dismissed, without prejudice to the debtor's right to refile another case under this chapter (or any other chapter of the Bankruptcy Code) and try again. There would be no provision for conversion of a case under this chapter to a case under chapter 7 or chapter 11 of the Bankruptcy Code.

7. If a case under this chapter is dismissed for failure to obtain the requisite plan acceptances, or otherwise, any future Bankruptcy Code proceeding by or against the debtor would have to be filed in the same court in which the first proceeding was filed.

8. Section 1145 of the Bankruptcy Code would apply to securities issued under the plan.

9. The Plan would be binding on only the debtor and the class or classes of creditors affected by the plan. There would be no discharge of any debt other than the specific class or classes of debt affected by the plan; as to such classes, the obligations of the debtor would be governed by the plan.

DISCUSSION

The primary benefit of the above proposal would be that a debtor seeking to modify a class of debt without unanimous consent would not be subject to all of the costs and burdens incident to a typical chapter 11 case: There would be no limitation or prohibition on the payment of prepetition debt; no need for court approval for out of the ordinary course of business transactions or, indeed, any other type of transaction, etc. The court's jurisdiction and control over the debtor would be limited to determining whether to approve the proposed debt modification and make it binding on the dissenters. Further, the broadened prohibition against the enforcement of *ipso facto* clauses would prevent the collateral damage that might otherwise accompany a chapter 11 filing.

Some time ago, the Committee discussed a similar concept. During those discussions, the following concerns (which are not necessarily consistent with one another) were expressed:

A. One committee member questioned the need for a special Bankruptcy Code provision for filing a summary proceeding in the bankruptcy court to obtain approval of the modification. Given the relative speed with which prepackaged plans involving the modification of the rights of a single class of creditors (such as bank debt or bonds) or even multiple classes of

liquidated debt for borrowed money can be confirmed, the summary proceeding really would not add very much in the way of greater speed, efficiency or economy. The countervailing argument is that the new proceeding would be substantially more streamlined and inexpensive and have less of an impact on creditors whose claims are not being modified than a prepackaged chapter 11 case, because there would be no automatic stay, no requirement of court approval for non-ordinary course transactions, and no restriction on the payment of pre-petition debt, etc. Further, unlike a prepackaged chapter 11 case, the new proceeding would not pose various risks to the debtor's value that can accompany the filing of a case under current chapter 11 of the Bankruptcy Code. Those avoided risks include: (i) the operation of ipso facto clauses in "safe harbored" commercial transactions (because such "safe harbors" would not apply in the new summary proceeding); and (ii) the inability to assume certain types of contracts such as certain non-exclusive intellectual property licenses (because the filing of the new proceeding would not constitute an enforceable default under any such contract, and all contracts that are not the basis for debt in the modified class would "ride through" without having to resort to a contested assumption process).

B. At the other end of the spectrum, concern was expressed that even with the requirement of Bankruptcy Court review and approval, there was insufficient protection for the minority because of the failure to include tests such as the "best interests" test in the new summary proceeding. This concern has been addressed by including a requirement that the "best interests" test be satisfied as to (i) any dissenting creditor in an impaired unsecured creditor class; and (ii) where rights as to collateral are modified in a manner that could not be accomplished outside of bankruptcy by the same majority of secured creditors in the class as voted to accept the plan, any dissenting holder of claims in a secured creditor class. Concern was also expressed that a dominant holder of the class of debt being modified (such as a single holder or commonly controlled group of holders) could vote for a plan that gave them control of the reorganized debtor and the minority little voice in its affairs. However, this concern could be addressed, at least in part, by providing that if a commonly controlled group of holders holds some large percentage of the debt in the class (for example, over 50%), a "numerosity" requirement would apply in addition to the requirement of an affirmative vote by the holders of the requisite majority in amount of claims. This requirement would apply only where a party objected to the approval of the modification on the grounds that a commonly controlled group of class members held more than 50% of the debt in the class. If that predicate was established, the burden would shift to the debtor to demonstrate that the requisite majority in number of claims had accepted the modification.

Small Business Bankruptcies

Friday, May 29, 2015
9:00 a.m.-10:00 a.m.

Prof. Edward R. Morrison
Josiah M. Daniel III
Hon. Pamela Pepper
Catherine L. Steege

A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize

National Bankruptcy Conference

January 3, 2010

Executive Summary

Today's small businesses have few options when they suffer financial distress. If they want to avoid liquidation, and if they are organized as a partnership or corporation, they must use Chapter 11 of the Bankruptcy Code. But judges, attorneys, and academics have known for years that Chapter 11 works poorly or not at all for small businesses. This law was designed for large corporations with extensive operations and complex capital structures, not small enterprises that depend critically on the skills of a single owner-manager and family members. The model for Chapter 11 was the publicly-traded manufacturer, not the local diner. As a result, many distressed small businesses are forced to wind down using antiquated state-law procedures instead of Chapter 11. If they do enter Chapter 11, their cases are often dismissed or converted to liquidation. The few that do succeed at reorganizing find that 20 percent or more of their assets were consumed by the administrative costs of the bankruptcy process.

There is a simple solution to this problem, and it already exists in another chapter of the Bankruptcy Code: Chapter 12, which now offers a reorganization opportunity for family farmers and family fishermen. This chapter provides a time-tested, successful model for efficient reorganization of small businesses. We recommend making it available to small businesses generally. With appropriate modifications, outlined in our proposal below, Chapter 12 would fill a gap in the reorganization laws for small businesses, save a significant number of viable small businesses from liquidation, and lower the costs of business failure for both small businesses and their creditors.

Our proposal begins with a statistical profile of small business bankruptcy, documenting the ill-fitting match between existing Chapter 11 and the problems of most small businesses. We then propose Chapter 12 as the appropriate solution and show that few legislative changes would be required to make this Chapter accessible to small businesses. The appendix presents the statutory amendments that would be necessary.

I. Motivation: Chapter 11 is a poor fit for small businesses

Bankruptcy judges, practitioners, and academics have known for decades that Chapter 11 works poorly or not at all for small businesses. There are many good reasons for this misfit. Fundamentally, Chapter 11 was conceived as a "big" business chapter with public companies as the model. Complex debt and asset structures arguably justify the SEC-style disclosures, multi-layered plans, voting and the like that characterize money-center Chapter 11 cases.[1] These same features make Chapter 11 too expensive, too complicated and too time consuming for small business debtors and their creditors.

Although a number of courts have fashioned local rules and practices that soften the unwelcoming aspects of Chapter 11,[2] they are limited to working with blunt tools, such as deadlines for submitting a plan and the threat of dismissal or conversion to Chapter 7. Some Local rules and practices have been counteracted by recent legislation (in 2005) that makes Chapter 11 less hospitable to small businesses by increasing disclosure requirements, compressing the time available, swamping cases with administration, and setting "drop dead" traps at every turn.[3]

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[1] *See, e.g.*, Hon. Leif M. Clark, *Chapter 11–Does One Size Fit All?*, 4 AM. BANKR. INST. L. REV. 167, 170-75 (1996).

[2] *See* Hon. A. Thomas Small, *Small Business Bankruptcy Cases*, 1 AM. BANKR. INST. L. REV. 305 (1993); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. SMALL & EMERGING BUS. L. 181, 205-07 & nn.78-85 (2000) ("The initiative in dealing with [the small success rate of small businesses in Chapter 11] came from the courts. Beginning in the late 1980s, some judges began to use their discretionary power to create a system of case management under which they could quicken the pace of cases that were proceeding too slowly and could more rapidly dismiss, or convert to Chapter 7, cases that had poor prospects of successful rehabilitation. The best known of these methods came to be known as the 'fast-track.' In essence, the fast-track procedure provided for an early evaluation by an official equivalent to the U.S. Trustee of all cases filed, to determine if they should be subject to an accelerated deadline for filing the plan. There were no specific articulated guidelines for this determination, which was made case by case and was not confined to debtors below any defined size. If the case was one for which accelerated treatment was appropriate, the court would order the debtor to file a plan by a specified date, usually sixty to ninety days following the order for relief. In addition, instead of following the usual (indeed, it can be argued, the required) procedure of conducting a formal hearing on notice to approve the disclosure statement before acceptances of the plan were solicited, the court informally reviewed the disclosure statement and would provisionally approve it if it appeared adequate. The final approval hearing, with an opportunity afforded for objections to the statement, was postponed to be combined with the plan confirmation hearing. If the debtor missed the deadline for plan filing set by the court, the case could be dismissed or converted unless the debtor could show cause for the delay. A short extension may have been granted if the plan was not confirmable, but the debtor would not be allowed wide latitude in producing a timely confirmable plan.") (footnotes omitted).

[3] *See, e.g.*, 11 U.S.C. §§ 308 (small business debtor reporting requirements), 1116 (additional duties of a debtor or trustee in a small business case); 1121(e) (reorganization plan must be submitted within 300 days), 1129(e) (plan must be confirmed within 45 days after plan is filed); 28 U.S.C § 586(a)(7) (establishing expanded U.S. Trustee duties and responsibilities in small business cases). *See also* Hon. A. Thomas Small, *If You Fix It, They Will Come–A New Playing Field for Small Business Bankruptcies*, 79

This section presents a statistical profile of the challenges small businesses experience in Chapter 11. Drawing on a wide range of empirical studies, there are four fundamental flaws in the current reorganization process for small businesses:

1. **Excessive Secured Creditor Influence**: Chapter 11 gives secured creditors excessive influence over the process,
2. **Monitoring Deficits**: Chapter 11 fails to give the judge or trustee sufficient information to monitor the firm's viability,
3. **High Costs:** Chapter 11 generates exorbitant administrative costs,
4. **Obstacles to Reorganization**: Chapter 11 includes a set of procedures (due in part to the reforms of 2005) that create serious roadblocks to reorganization.

Section II explains how Chapter 12 can remedy these problems.

A. Small Business Chapter 11s: Basic Facts

Several recent studies have produced basic facts about the small business Chapter 11 process, including:

- IL Study: analyzed bankruptcy filings during 1998 and 2006 in the Northern District of Illinois. The study excluded filings by non-corporate, non-profit, and real estate businesses.[4]
- NY/AZ Study: analyzed filings between 1995 and 2001 in the Southern District of New York and the District of Arizona. The study excluded cases that were dismissed or converted to Chapter 7.[5]
- Multi-District Study: analyzed filings during 1998 and 2006 in a variety of districts (23 districts in 1998 and 9 in 2006). The study includes filings by individuals, partnerships, and corporations.[6]

AM. BANKR. L.J. 981, 982 (2005) ("These provisions probably will not reduce costs, and certainly do not address most of the roadblocks that confront a small business Chapter 11 debtor.").

[4] Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381 (2007); Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005); and Douglas G. Baird & Edward R. Morrison, *Adversary Proceedings: A Sideshow*, 79 Am. Bankr. L.J. 951 (2005).

[5] This study produced Douglas Baird, Arturo Bris & Ning Zhu, *The Dynamics of Large and Small Chapter 11 Cases: An Empirical Study*, working paper (2007), and Arturo Bris, Ivo Welch & Ning Zhu, *The Costs of Bankruptcy: Chapter 7 Liquidation versus Chapter 11 Reorganization*, 61 J. Fin. 1280 (2006).

[6] Papers from this study include Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009); Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L. J. 499 (1999).

- D&B Studies: analyzed Dun & Bradstreet data on small business closures. One study analyzed distressed businesses in Cook County during the period 1998 to 2005.[7] Another analyzed a nationally representative sample of small business closures during 2004 and 2006.[8] Both studies included data on corporations, proprietorships, and partnerships that filed for bankruptcy or shut down without filing.
- Tax Studies: several papers have studied the pervasiveness and composition of small business tax debts.[9]

These studies report the following patterns:

Small businesses have relatively simple capital structures and many wind down or reorganize without filing for bankruptcy. Among businesses with less than $200,000 in assets, the NY/AZ Study found, the median firm has only 1 or 2 secured creditors, neither of which is usually a bank.[10] The number of unsecured creditors is fewer than 20 for the median firm, and a bank is rarely, if ever, among these creditors.[11] Due to the simplicity of their capital structures, distressed small businesses frequently resolve their distress without filing for bankruptcy. For example, the D&B Studies found that 80 percent of distressed businesses wind down or reorganize without filing. Bankruptcy is most attractive to firms with a relatively large number of creditors (e.g., 3 or more secured creditors).[12]

Secured debt accounts for a large share of total debt and assets, but significant value remains for unsecured creditors. Data from the IL Study, for example, show that secured debt accounted for 23 percent of total debt and 51 percent of total assets in the median firm.[13]

Administrative costs of Chapter 11 are significant. Looking across both Chapter 7s and confirmed Chapter 11s, the NY/AZ found that median professional fees equaled 23% of asset value (as reported at filing) among firms with assets worth less than $100,000. Fees equaled 4.9% of assets among firms with assets worth between $100,000 and $1 million and about 1% among larger firms.[14] Another study, of individual and business Chapter 11s in six geographically diverse districts between 1986 and 1993, found administrative costs equal to 3.5

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[7] Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255 (2009).

[8] Edward R. Morrison, *Bankruptcy's Rarity, Small Business Workouts in the United States*, 5 Eur. Company & Fin. L. Rev. 172 (2008); Edward R. Morrison, *Small Business Bankruptcy and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, Report Submitted to the Small Business Administration (2008).

[9] These include Rafael Efrat, *The Tax Debts of Small Business Owners in Bankruptcy*, 24 Akron Tax L. J. 175 (2009); Rafael Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, 4 Hastings Bus. L. J. 175 (2008); Baird, et al., *Dynamics of Large and Small Chapter 11 Cases*, *supra* note 5; and Baird & Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, *supra* note 4.

[10] Baird, Bris & Zhu, *supra* note 2, at 18-9.

[11] *Id.*

[12] Morrison, *Small Business*, *supra* note 1, at 6.

[13] These statistics were computed for this proposal.

[14] Bris, Welch & Zhu, *supra* note 2, at 1282

percent of assets (at filing) in the median case ("Lawless, et al., Study").[15] Practitioners claim that these costs exceed those of comparable state procedures such as assignments for the benefit of creditors.[16]

Administrative costs and priority tax claims consume the bulk of unencumbered property in confirmed Chapter 11s. The NY/AZ study calculated the median recovery rate for creditors holding non-priority unsecured claims. It was zero among firms with assets (at filing) under $200,000 and around 3 percent among firms with assets under $2 million. Priority tax claims, in particular, constituted a large fraction of total debt, accounting for 20 percent or more of unsecured debt among firms with assets under $2 million.[17] The Lawless et al., Study found that professional fees and other administrative expenses consumed about 18 percent of distributions to unsecured creditors in the median case.[18]

Most Chapter 11s terminate in dismissal or conversion to Chapter 7. The IL study found that, among firms with debt under $2 million, dismissal or conversion occurred in 77% of cases filed during 1998 and 66% of cases filed during 2006.[19] Similarly, the Multi-District study found dismissal or conversion in 70% of cases filed in 1994 and 67% of those filed in 2002.[20] These patterns are consonant with those reported by the National Bankruptcy Review Commission, which observed that "only a small fraction of the Chapter 11 cases filed nationwide end in confirmation of a plan of reorganization."[21] Failure to reach confirmation, however, is not necessarily an indicator of failure. A "successful" Chapter 11 could culminate in dismissal because the debtor has resolved its problems or has found a buyer.[22]

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[15] Robert M. Lawless & Steven Ferris, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. Pitt. L. Rev. 629, 651 (1999-2000).

[16] *See, e.g.*, Melanie Rovner Cohen & Joanna L. Challacombe, *Assignment for the Benefit of Creditors—Contemporary Alternatives for Corporations*, 2 DePaul Bus. L. J. 269, 270 (1990) ("In contrast to a Chapter 7 liquidation under the Bankruptcy Code, an assignment [for the benefit of creditors (ABC)] is generally more efficient, less costly, of shorter duration, more successful in terms of the value received for the assts and amounts paid to creditors and more tailored to the needs of debtors and their creditors."); David S. Kupetz, *Assignment for the Benefit of Creditors: Advantageous Vehicle for Selling and Acquiring Distressed Enterprises*, 6 J. Private Equity 16, 18 (2003) ("Compared to bankruptcy liquidation, assignments may involve a faster and more flexible liquidation process."); Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High-Tech Firms*, 82 Wash. U. L. Q. 1375, 1392-93 (2004) (concluding, based on interviews with practitioners, that "the net cost of the [ABC] process seems to be less than a bankruptcy proceeding"); Bruce C. Scalambrino, *Representing a Creditor in an Assignment for the Benefit of Creditors*, 92 Ill. Bar J. 263 (2004) (explaining that under Illinois law, "ABCs take less time than bankruptcy and require less in the way of court intervention and approval, which can mean lower professional fees for debtors.").

[17] Baird, Bris & Zhu, *supra* note 2, at Table 5.

[18] Robert M. Lawless, et al., *A Glimpse at Professional Fees and Other Direct Costs in Small Firm Bankruptcies*, 1994 U. Ill. L. Rev. 847, 863 (1994).

[19] Morrison, *Small Business*, *supra* note 1, at 79.

[20] Warren & Westbrook, *Success*, *supra* note 3, at 615.

[21] NBRC Report, *supra* note 6, at 610.

[22] Warren & Westbrook, *Success*, *supra* note 3, at 610-11. The IL Study found that about 17% of dismissals involved debtors that had undergone a going-concern sale or had hammered out an agreement

Most dismissals and conversions occur early in the case, pointing to quick decision-making by the judge. In the IL study, 70% of dismissals and conversions occurred within the first 6 months of the case; 44% occurred within three months.[23] That study also marshaled evidence showing that judges were adept in distinguishing viable and non-viable firms.[24] Consistent evidence is presented in the Multi-District study, which finds that the probability of confirmation was 47% among firms that avoided dismissal or conversion during the first 6 months. The probability rose to 67% among those that avoided those outcomes during the first 12 months. Judges "pushed the losers out early."[25]

Debtor in possession (DIP) financing appears uncommon. To our knowledge, the best available evidence is from a study of small business filings between 1986 and 1994 in the Northern District of Georgia.[26] That study found DIP financing (new loans or lines of credit that must be approved by the court) in 10 percent of Chapter 11s. The financing was rarely provided by a bank; 95 percent of loans were extended by suppliers with secured prepetition claims. On the other hand, the authors did not investigate the frequency and terms of cash collateral orders based on prepetition credit relationships, which can serve as a substitute for DIP loans and can subject debtors to the kinds of control often seen in DIP loans.

Small businesses make up the vast majority of Chapter 11 filings. The IL study found that 75 percent of debtors had debt under $2 million and 77 percent had fewer than 20 employees.[27] Similar statistics are reported in the Multi-District Study. The NY/AZ Study found that, among confirmed Chapter 11s, median asset value was about $1.2 million.[28] Likewise, the National Bankruptcy Review Commission surveyed 1995-97 data from six districts and found that that 72 percent of debtors had debt under $2 million.[29]

Many Chapter 11s involve businesses with little measurable value as a going concern relative to liquidation. Value as a going concern typically stems from specialized assets. The IL Study found that at most 5.5 percent of the median firm's assets were specialized. Excluding restaurants, the percentage falls to 2.2. These percentages characterize firms with confirmed plans as well as those whose cases were dismissed or converted.[30]

Chapter 11s can function as a "waiting period" for serial entrepreneurs as they consider their next ventures and resolve personal liability for business debts. The IL Study found that, among cases that were dismissed or converted, 70 percent of owner-managers went on to start

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with key creditors. Morrison, *supra* note 4, at 390 tab. 4. Another 23% survived more than one year after the case was dismissed. *Id*., at 291 tab. 5.

[23] Morrison, *Continuation Bias*, *supra* note 1, at 391.

[24] *Id*., at 441.

[25] Warren & Westbrook, *Success*, *supra* note 3,at 621.

[26] Jocelyn Evans and Timothy Koch, *Surviving Chapter 11: Why Small Firms Prefer Supplier Financing*, 31 J. Econ. & Fin. 186, 191 (2007).

[27] These statistics were computed for this proposal.

[28] Bris, Welch & Zhu, *supra* note 2, at 1258.

[29] NATIONAL BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 631 (1997) (Hereinafter "NBRC Report").

[30] *Id.* at 2332.

new businesses or continued running other, non-bankrupt businesses. 85 percent of the owner-managers had founded a separate business in the past or went on to start another after the case was dismissed or converted.[31] This may be unsurprising because entrepreneurs are highly unlikely to exit self-employment once they have owned businesses for several years.[32]

Tax claims and personal guarantees are ubiquitous in small Chapter 11 cases. The IL Study, for example, found that the owner-manager was personally liable for business debts in 85 percent of the cases, due to personal guarantees (56 percent of cases) or liability for trust fund taxes (61 percent).[33] Another study surveyed owners of small businesses that filed for bankruptcy in the Central District of California (San Fernando Valley Division) during 2004 and 2005.[34] Thirteen percent of respondents stated that tax liabilities were a cause of their bankruptcy filings.

Unsecured creditors' committees are rarely formed in small Chapter 11 cases. The IL Study found unsecured creditors' committees in only 3% of cases in which business debts were less than $2 million (2% in 1998, 6% in 2006).[35] The percentage rises to about 8% in cases reaching plan confirmation. By contrast, among firms with debt greater than $2 million, a committee was formed in 33% of the cases. Another study reports similar statistics based on a quasi-random sample of cases throughout the United States.[36] It finds a committee in 19 percent of cases generally (median debt equal to $1.2 million) and in 67 percent of cases involving large publicly-traded and privately-held firms (median debt equal to $50.2 million). Similar statistics were reported by the National Bankruptcy Review Commission.[37]

BAPCPA appears to have placed additional demands on the cash flow of Chapter 11 debtors. Sections 366(b), (c), and 503(b)(9) of the Bankruptcy Code now require the debtor to deposit cash sufficient to offer "adequate assurance" to utility suppliers and to give administrative expense priority to claims for goods supplied within 20 days of the bankruptcy petition. Although no empirical work has studied these sections yet, they likely impose larger burdens on small businesses than large firms because small businesses appear to face greater borrowing constraints.[38] Put differently, Sections 366(b) and 503(b)(9) increase the cost of

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[31] Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2337-40.

[32] *See, e.g.*, David S. Evans & Linda S. Leighton, *Some Empirical Aspects of Entrepreneurship*, 79 Am. Econ. Rev. 519 (1989) (studying 1966-81 data from the National Longitudinal Study of Youth and finding that the probability of exiting self-employment falls to zero after eleven years of owning a business).

[33] Baird & Morrison, *Serial Entrepreneurs*, *supra* note 1, at 2362 tab. 17.

[34] Efrat, *The Tax Burden and the Propensity of Small-Business Entrepreneurs to File for Bankruptcy*, *supra* note 9, at 201.

[35] These statistics were computed for this proposal.

[36] Stephen Lubben, *Corporate Reorganization and Professional Fees*, 82 Am. Bankr. L. J. 77, 93-95 (2008).

[37] NBRC Report at 642.

[38] William M. Gentry & Glenn R. Hubbard, *Entrepreneurship and Household Saving*, 4 Adv. in Econ. Anal. & Policy, article 8 (2004), available at http://www.bepress.com/bejeap/advances/vol4/iss1/art8. *But compare* Erik Hurst & Annamaria Lusardi, *Liquidity Constraints, Household Wealth, and Entrepreneurship*, 112 J. Pol. Econ. 319 (2004) (doubting the importance of liquidity constraints for small businesses) *with* Robert W. Fairlie & Harry A. Krashinski, *Liquidity Constraints, Household Wealth, and*

Chapter 11 by forcing a small business to generate sufficient cash flow to cover these requirements immediately.

B. Fundamental problems in small business Chapter 11s

The foregoing statistical patterns suggest that when a small business attempts reorganization, these problems loom large:

1. **Excessive Secured Creditor Influence.** Due to the small stakes for unsecured creditors, and the rarity of creditors' committees, secured creditors have excessive influence.
2. **Monitoring Deficits**. Without active involvement from unsecured creditors, it can be difficult for a judge to assess whether the firm is a viable candidate for reorganization. The judge must rely heavily on the U.S. Trustee or bankruptcy administrator, but he or she is primarily concerned about the debtor's compliance with procedural requirements. Because around two-thirds of all cases end in dismissal or conversion, one of the judge's most important jobs is to "filter out" non-viable cases as quickly as possible. Although judges have developed tools for doing this, the success of these tools likely depends on the amount of time and effort that judges can devote to monitoring and supervising cases, something the 1978 Code discourages.[39]
3. **High Costs**. Administrative costs consume a significant percentage of firm value. These costs may deter distressed businesses, the majority of which use non-bankruptcy procedures (negotiation with creditors, assignments for the benefit of creditors, etc.) to resolve financial distress.
4. **Obstacles to Reorganization**. BAPCPA's new requirements with respect to administrative expenses and adequate assurance effectively tax the cash flow of cash-strapped businesses, undermining chances for successful reorganization.

To be sure, the first three of these issues are not new. Monitoring Deficits and High Costs in particular were a concern of the National Bankruptcy Review Commission, which was created by Congress in 1994 to study the Bankruptcy Code.[40] With respect to the first issue, the Commission recommended, and BAPCPA adopted, various measures to give the U.S. Trustee greater power to monitor small business cases and to increase the information available to the court and Trustee. For example, the U.S. Trustee is now instructed to investigate the debtor's viability at the outset of the case,[41] and the debtor is instructed to submit periodic financial

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Entrepreneurship Revisited, (IZA Discussion Paper No. 2201 2006), available at http://ssrn.com/abstract=920640 (challenging the work of Hurst & Lusardi).

[39] *See, e.g.*, Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 Am. Bankr. L.J. 431, 4333-35 (1995); Dennis S. Meir & Theodore Brown, Jr., *Representing Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 56 Am. Bankr. L.J. 217, 217 (1982).

[40] The commission's history is discussed at this website: http://govinfo.library.unt.edu/nbrc/facts.html.

[41] 28 U.S.C. § 586(a)(7).

reports and schedules, attend all meetings, timely pay taxes, and maintain insurance.[42] Although BAPCPA extended the exclusivity period (from 100 to 180 days[43]) and deadline for submitting a plan (from 160 days to 300 days[44])—contrary to the Commission's recommendation[45]—the Act imposed a new 45-day deadline for achieving plan confirmation.[46] These changes increased the obligations on small businesses but did not necessarily create the conditions to facilitate reorganization. Furthermore, BAPCPA reduced judges' discretion in determining whether to dismiss or convert chapter 11 cases even though the empirical research reviewed earlier suggests that courts had good track records of sorting viable and nonviable cases.[47]

The National Bankruptcy Review Commission addressed High Costs to some extent by recommending that disclosure statements be simplified or eliminated in small business cases and that courts promulgate standardized disclosure statements and reorganization plans. The first recommendation found its way into BAPCPA,[48] and there are now Official Forms for small business plans and disclosure statements.[49] Although this was a useful step, it did not address the many other ways in which Chapter 11 produces considerable administrative costs in small business cases.

II. Chapter 12 is a solution to the problems facing small business reorganizations

A promising fix to the problems of reorganizing small businesses already exists in the Bankruptcy Code. That approach, chapter 12, was enacted in response to a small business problem not unlike the one we face today. During the early 1980's (and still today), farms were small businesses, often owned by members of a single family. Farm product prices were falling because of technological advances, improved transportation and mechanization and the growth of corporate farms.[50] The value of farmland was falling, especially in the Midwest. The lenders to farmers were in crisis for many reasons, including an avalanche of failed or failing banks that reduced the availability of credit. Lending to small business farmers dried up. Farmers couldn't put in crops and soon could not make their mortgage payments.

Many small farm businesses attempted to reorganize in Chapter 11 cases.[51]These cases inevitably failed for several reasons.[52] Small farmers often could not afford the cost of the

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[42] 11 U.S.C. §§ 308, 1116.
[43] § 1121(e)(1).
[44] § 1121(e)(2).
[45] NBRC Report, at 64-65.
[46] 11 U.S.C. § 1129(e).
[47] 11 U.S.C. § 1112(b).
[48] § 1125(f).
[49] *See* http://www.uscourts.gov/bkforms/bankruptcy_forms.html#official.
[50] This paragraph draws on the discussion in Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 484-86 (2005); Steven Shapiro, Note, *An Analysis of the Family Farmer Bankruptcy Act of 1986*, 15 Hofstra L. Rev. 353, 360-62 (1987).
[51] Shapiro, *supra* note 50, at 364.
[52] This paragraph draws from Hon. A. Thomas Small, *Chapter 12-The Family Farmer Bankruptcy Act of 1986*, 1987 Norton Ann. Surv. Bankr. L. 1.

process.[53] Farm lenders lacked flexibility to negotiate outcomes that would work for small farm reorganizations. Lenders secured by farmland were often undersecured (that is, their debt exceeded the value of the property) and could vote the unsecured portion of their claims to defeat confirmation of any plan. Farmers in Chapter 11 could not sell part of their farms to reduce the operation to a size that was viable without the consent of their lenders.[54] Chapter 13 was rarely a useful alternative because the debt limits were too low,[55] only individuals were eligible[56] and the tools for management of secured debt were not robust enough to help farmers.[57]

At the urging of Senator Grassley (R. Iowa) and the late Congressman Mike Synar (D. Okla.), Chapter 12 of the Bankruptcy Code was hatched to address the reorganization needs of farm businesses. The instructions from Synar and Grassley were simple: draft a new reorganization chapter accessible for farm businesses up to a certain size with ownership limited to the members of an extended family without the disclosure, voting and other complications of Chapter 11. The basic rights of creditors in a Chapter 11 case must be retained. Unsecured creditors must be paid at least what they would receive in a liquidation of assets under Chapter 7. Secured creditors must receive surrender of their collateral or the debtor must pay the "present value" of that collateral (meaning, with interest) through the plan. In recognition of the long-term nature of loans secured by farmland and equipment, farm businesses must be able to pay secured creditors (with interest) over an appropriate period of years. Legislation creating Chapter 12—The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986[58]—was signed into law by President Reagan on October 27, 1986. The law became effective November 26, 1986.[59]

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[53] H.R. Conf. Rep. 99-958 at 5249, 1986 USCCAN 5246 (Oct. 2, 1986) ("Most family farmers have too much debt to qualify as debtors under Chapter 13 and are thus limited to relief under Chapter 11. Unfortunately, many family farmers have found Chapter 11 needlessly complicated, unduly time-consuming, inordinately expensive and, in too many cases, unworkable.").

[54] *Id*. ("Most family farm reorganizations, to be successful, will involve the sale of unnecessary property. [Section 1206] . . . allows Chapter 12 debtors to scale down the size of their farming operations by selling unnecessary property. This section modifies 11 USC 363(f) to allow family farmers to sell assets not needed for the reorganization prior to confirmation . . . the creditor's interest . . . would attach to the proceeds of the sale.").

[55] *See* 11 U.S.C. § 109(e) (secured and unsecured debt limitations for Chapter 13). *See also* Joshua T. Crain, *Resolution of an Apparent Conflict: Rowley versus Anderson*, 10 DRAKE J. AGR. L. 483, 486 (2005) ("debt limits allowed under Chapter 13 were too low for most family farmers").

[56] § 109(e) ("Only an individual with regular income . . . may be a debtor under chapter 13 of this title."). "Individual with regular income" is defined in § 101(30) to mean "an individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13 of this title[.]"

[57] In Chapter 13, farmers could not modify real estate secured loans and were limited in ability to sell property. *See, e.g.*, § 1322(b)(2).

[58] Pub. L. No. 99-544, 100 Stat. 3105 (1986).

[59] Pub. L. No. 99-544, § 302(a).

A. Comparing Chapters 11 and 12

Table 1 sets out key differences between small business reorganization under Chapters 11 and 12. Perhaps the most important differences involve the appointment of a standing trustee, tighter deadline for submitting a plan of reorganization, lower repayment obligations, and more flexible treatment of administrative expenses in Chapter 12.

Although the debtor remains in control of his or her business regardless of the Chapter, only Chapter 12 mandates the appointment of a standing trustee in every case.[60] The trustee is charged with responsibility to monitor the case and to be heard at any hearing involving the valuation or sale of assets or the confirmation or modification of a plan.[61] The standing trustee ensures that the court receives an unbiased, continuous flow of information about the firm's viability.

Chapter 12 also imposes stricter deadlines on the submission of plan of reorganization: a plan must be submitted within 90 days[62] and either confirmed or rejected no more than 45 days later.[63] This contrasts with the much longer deadlines (300 days for plan submission) under Chapter 11's small business provisions.[64] The strict deadlines in Chapter 12 prevent firms from using the Code solely as a means for thwarting creditor collection efforts.

In Chapter 12, family farmers and fishermen can retain ownership interests in their businesses even if they cannot pay creditors in full. This outcome is prohibited by Chapter 11's absolute priority rule, but permitted under Chapter 12 because unsecured creditors are instead entitled to all of a Chapter 12 debtor's disposable income for up to five years[65] following plan confirmation and must receive at least what they would be paid in a Chapter 7 liquidation.[66] At the end of the repayment period, any unpaid unsecured claims are discharged. (Secured claims must be repaid in full, but payments can exceed the five year period of the Chapter 12 plan[67]). These repayment rules ensure that a family farmer or fisherman does not engage in wasteful efforts to avoid bankruptcy for fear of losing ownership of the business. As long as secured creditors are repaid in full and unsecured creditors receive all of the business's disposable income for up to five years, the farmer or fisherman can retain ownership.

Finally, Chapter 12 offers debtors greater flexibility in repaying administrative expenses, such as attorney fees and the claims of suppliers who delivered goods within 20 days prior to the bankruptcy petition.[68] Chapter 11 requires immediate payment in cash on the date of confirmation (unless the claimants agree to different treatment).[69] Because family farmers and

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[60] 11 U.S.C. § 1202.
[61] § 1202(b).
[62] § 1221.
[63] § 1224.
[64] §§ 1121(e)(2) (300 day deadline for submitting plan), 1129(e) (45 day deadline for confirmation hearing).
[65] §§ 1222(c), 1225(b).
[66] § 1225(a)(4).
[67] § 1225(a)(5).
[68] § 1222(a)(2).
[69] § 1129(a)(9).

fisherman, like all small businesses, are often cash-strapped, the Chapter 11 rule creates barriers to confirming a plan. Chapter 12 eliminates this barrier by permitting gradual repayment of attorney fees and other administrative expenses over time.

Since its enactment in 1986, thousands of family farmers and fishermen have reorganized under Chapter 12.[70] Figure 1 plots the number of Chapter 12 filings since the law's enactment. Although Chapter 12 began as an emergency measure, Congress made it a permanent part of the Code—and made it available to family fishermen as well as farmers—in the Bankruptcy Abuse and Consumer Protection Act of 2005.[71] Although the law has not been used frequently in recent years, this could be seen as a measure of its success.[72] Over time, lenders and farm owners have come to understand what happens in a Chapter 12 case; many small farm businesses have been able to reorganize without resorting to bankruptcy.

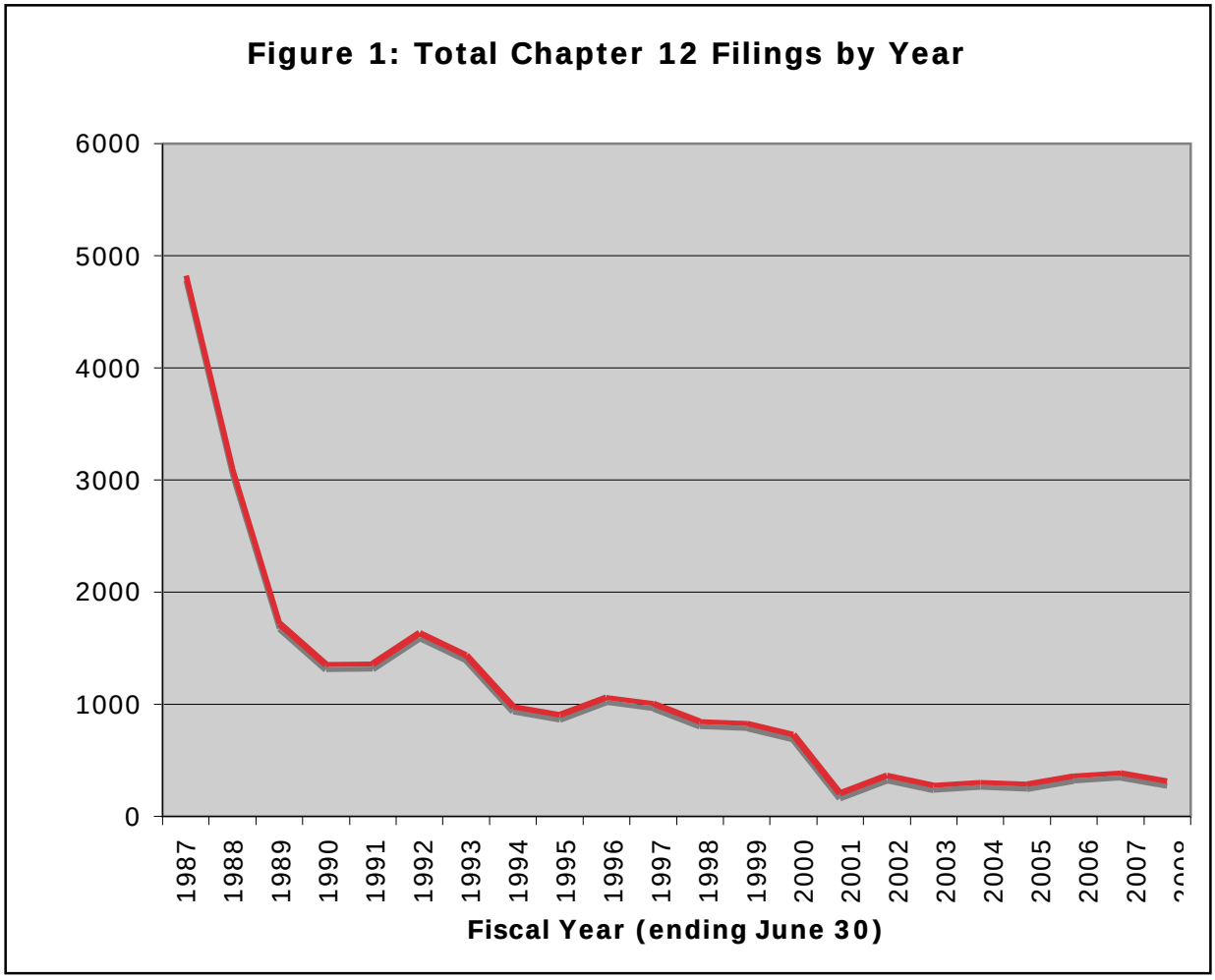
[70] *See, e.g.*, Jonathan K. Van Patten, *Chapter 12 in the Courts*, 38 S.D.L.R. 52, 54-55 (1993).

[71] BAPCPA made Chapter 12 permanent as of July 1, 2005, to coincide with expiration of the 2004 extension.

[72] *See, e.g.*, Katherine M. Porter, *Phantom Farmers: Chapter 12 of the Bankruptcy Code*, 70 AM. BANKR. L.J. 729, 743 (2005) ("Chapter 12 may have its greatest effect in the shadow of bankruptcy. The mere existence of Chapter 12 influences a creditor's willingness to engage in loan workouts because the creditor must evaluate its recovery if the debtor filed bankruptcy. By defining the boundaries of what each party's rights will be in bankruptcy, Chapter 12 provides a firm structure against which debtors and creditors can negotiate in restructuring loans. All of bankruptcy law has this potential, but Chapter 12 offers a particularly powerful incentive for creditors to reach a non-bankruptcy resolution. Compared to Chapter 11, a creditor in a Chapter 12 case has relatively few tools at its disposal to derail a debtor's effort to reorganize. A survey of attorneys who represented distressed farmers or agricultural creditors found that between one-third and half of disputes were negotiated successfully. Attorneys cited the existence of Chapter 12 as an 'influencing factor in 58.06 percent of these successful negotiations.' The 'shadow' effect of Chapter 12 is difficult to measure exactly but Chapter 12 appears to provide substantial assistance to farmers in obtaining a forbearance or write down of their debt even if no bankruptcy case is ever filed.") (footnotes omitted).

Table 1: Comparison of Chapters 11 and 12

Issue	Chapter 11 (small business provisions)	Chapter 12
Eligibility	Any individual or business described in 109(d).	Any family farmer or fisherman with regular annual income, including a corporation
Involuntary filings permitted	Yes	No
Debtor remains in possession of business?	Yes	Yes
Unsecured creditors committee can be formed	Yes	No
Standing trustee	No	Yes
Debtor has exclusive right to file a plan of reorganization	No: debtor has exclusivity only for the first 180 days	Yes
Deadline for filing plan of reorganization	Yes: 300 days	Yes: 90 days
Maximum term of plan	No	Yes: five years
Creditors vote on the plan	Yes	No: creditors may object to a plan; the court rules on the objections
Creditors entitled to full payment before owner receives value	Yes, except in cases filed by individual debtors	No: creditors are entitled to all of debtor's projected disposable income for up to five years.
Administrative expenses must be paid in full at plan confirmation	Yes	No: deferred cash payments are acceptable
Secured debt repayments can exceed the term of the plan	No	Yes
Secured claims can be modified, including reducing secured debts to the value of the collateral	Yes, except for home mortgages in individual debtor cases	Yes
Plan must pay creditors at least what they would receive in liquidation	Yes	Yes



Source: Administrative Office of the U.S. Courts

B. Making Chapter 12 available to small businesses generally

Family farmers and fishermen are small businesses, and Chapter 12 has proven to be a viable, low-cost reorganization procedure. Chapter 12 would be equally effective in addressing the needs of small businesses generally. As the foregoing discussion has shown, it addresses the key problems facing small business corporations seeking to reorganize:

1. **Excessive Secured Creditor Influence:** The influence of secured creditors is moderated by the presence of a standing trustee and the debtor's ability to confirm a reorganization plan without a creditor vote.

2. **Monitoring Deficits**. The standing trustee provides a continuous, unbiased source of information about the debtor's viability. In a small business case, the trustee "would give impartial oversight of the debtor's operations, examine the debtor's affairs, make recommendations concerning confirmation of the plan, mediate disputes, monitor compliance for three years after confirmation, and carry out the terms of the plan if the debtor does not."[73]

3. **High Costs**. Administrative costs are reduced by tight deadlines for submitting plans of reorganization, the elimination of big-case procedures such as the Chapter 11 disclosure statement, and the court's ready access to information about the debtor's viability.

4. **Obstacles to Reorganization**. Chapter 12 imposes fewer demands on the debtor's cash flow by allowing administrative expenses to be paid over time after plan confirmation.

A relatively small number of amendments would be necessary to make Chapter 12 available to small businesses generally. The following paragraphs discuss the amendments. In an Appendix, we present draft legislation.

Eligibility: In addition to family farmers and fishermen, only small business enterprises should be eligible to use Chapter 12. We propose making Chapter 12 available to a "small business enterprise" ("SBE"), defined as a corporate or non-corporate person—other than a family farmer or family fisherman—who is engaged in a business or commercial activity and has total debts not exceeding $10 million, provided at least fifty percent of the debt arises from the person's business or commercial activities. This definition would appear in new Section 101(51E). We would amend Section 109(f) to state that a SBE is eligible to be a debtor under Chapter 12 only if the SBE has regular income. (A technical amendment to Section 104(a) would be needed to periodically adjust the $10 million threshold for inflation.)

Our proposed definition of a SBE is broader than the Code's current definition of a "small business debtor," which includes any business with total debt not exceeding $2 million.

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[73] Small, *If You Fix It, They Will Come*, *supra* note 3, at 983. *See also*, Hon. A. Thomas Small, *Paying the Piper: Rethinking Professional Compensation In Bankruptcy—Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305 (1993); Hon. A. Thomas Small, *Suggestions for the National Bankruptcy Review Commission and Congress*, 4 Am. Bankr. Inst. L. Rev. 550 (1996).

We do not propose changing the definition of a small business debtor. A SBE should remain free to use Chapter 11 if that is a preferable option. And if it qualifies as a small business debtor, it will be subject to the special rules governing those businesses in Chapter 11.

Rights and powers of the debtor: Many small businesses enter bankruptcy with debts to their attorneys and accountants. Section 327(a) requires that the debtor's attorney or accountant must be "disinterested" during the pendency of the case. Section § 101(14), in turn, states that a creditor is not a disinterested person. It would be unduly burdensome to force small businesses to find new attorneys or accountants after commencing a Chapter 12 case. We therefore propose amending Section 1203 to declare that a professional person is not disqualified from employment solely because he or she has a prepetition claim. This amendment would apply to all debtors in a Chapter 12 case, not just SBEs.

Reporting requirements: SBEs should be subject to most of the same reporting requirements in Chapter 12 that are currently applicable to small business debtors in Chapter 11. We therefore propose adding new Section 1209, which largely replicates the requirements of § 308 and § 1116. In order to clarify that 1209 captures the full reporting duties of a SBE, we propose amending § 308 to apply only in small business Chapter 11 cases.

***Discharge*:** The date on which a debtor obtains a discharge varies by Chapter and debtor. In cases under Chapter 12, all debtors typically receive a discharge upon completion of payments,[74] but may also receive a discharge before completing all payments if creditors have already been paid what they would receive in a liquidation and if the failure to complete payments is due to circumstances for which the debtor should not justly be held accountable.[75] In cases under Chapter 11, the rule varies by debtor. Corporate debtors receive discharge at confirmation.[76] Among *individual* debtors, three rules govern discharge: a court can grant discharge (i) upon completion of plan payments,[77] (ii) prior to completion of plan payments if creditors have already received at least what they would expect in a liquidation and modification of the plan is not practicable,[78] or (iii) at confirmation or any other date prior to completion of plan payments if the court determines—for cause and after notice and hearing—that an earlier date for discharge is appropriate.[79]

We propose applying the Chapter 11 individual debtor rules to SBEs in Chapter 12. Discharge should typically be available after the SBE completes plan payments, but the judge should have discretion to grant an earlier discharge *either* for cause *or* because creditors have already received their liquidation rights and circumstances beyond the debtor's control prevent further payments. Although it would be the exceptional case in which a SBE merits discharge at confirmation, the court should have authority to grant such a discharge.

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[74] § 1228(a).
[75] § 1228(b).
[76] § 1141(c).
[77] § 1141(d)(5)(A).
[78] § 1141(d)(5)(B).
[79] § 1141(d)(5)(A). *See also* In re *Sheridan*, 391 B.R. 287 (Bankr. E.D.N.C. 2008).

C. Potential Controversies

Several aspects of Chapter 12 merit further discussion: treatment of residential mortgages, creditor voting, creditors' committees, and appointment of standing trustees.

Residential mortgages. Chapter 12 permits debtors to restructure secured debt, including real estate mortgages that are secured by the debtor's residence.[80] The value of the secured claim can be reduced to the value of the collateral. That value must be paid over time with interest, but the difference between the original secured debt and the value of the collateral—the deficiency—is treated as an unsecured claim. Although Chapter 12 debtors can therefore "cram down" a home mortgage, this right would be available only to SBEs that own residences. Thus, a sole proprietor would be able to cram down a residential mortgage. That power is already possessed by family farmers and fishermen.[81] Similarly, a corporate SBE could cram down a home mortgage, provided the corporation owned the residence. This power too is already possessed by any corporation or partnership that files a Chapter 11 case.[82]

It is important to emphasize, however, that most real estate secured debts, such as residential home mortgages, would not find their way into Chapter 12. Few residences are owned by the types of small businesses—enterprises that are engaged in commerce or business and whose debts are primarily business-related—that would be newly eligible for Chapter 12. Ordinary wage earners would not be eligible for an expanded Chapter 12.

Voting. Creditors have the right to vote on small business chapter 11 plans today but would not have the right to vote on small business plans in chapter 12. This is an important change, but is not a significant concern for the following reasons. First, small businesses already use Chapter 13, which does not permit creditor voting.[83] Second, it is the experience of bankruptcy professionals everywhere that creditors don't participate in small business Chapter 11 cases even though they have the right to vote on plans.[84] For the most part, small business cases simply aren't large enough to command the attention of individual creditors. Voting is a possibility but rarely a reality in small business Chapter 11 cases.

Furthermore, voting is not essential to protect unsecured creditors because chapter 12 expressly requires debtors to pay creditors in accordance with specified standards. With respect to unsecured creditors, Chapter 12 contains a "those who can pay should pay" provision.[85] Upon appropriate objection, every Chapter 12 debtor must commit all projected disposable income to payments to creditors for no less than three years.[86]

Unsecured creditors committee. Chapter 12 does not permit formation of official creditors' committees, but this change will impose few if any burdens on unsecured creditors. As

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[80] § 1222(b)(9) and (c).
[81] *Id.*
[82] § 1123(b)(5).
[83] § 1325.
[84] *See* Small, *If You Fix It, They Will Come*, *supra* note 3, at 983-84.
[85] § 1225(b).
[86] § 1225(b)(1)(B).

noted above,[87] these committees are rarely formed in small business cases. Instead of committees, Chapter 12 relies on the standing trustee to protect the rights of unsecured creditors. Because a trustee is appointed in every Chapter 12 case, but a committee is rarely assembled in a Chapter 11 case, unsecured creditors will generally enjoy greater protection in Chapter 12 cases.

Trustee caseload and compensation. As SBEs begin using Chapter 12, the caseload of Chapter 12 trustees will increase dramatically. There were only 345 Chapter 12 filings but nearly 10,000 Chapter 11 cases during calendar year 2008.[88] The bulk of Chapter 11 cases are filed by small businesses.[89] Again, this proposal would not preclude SBEs from filing Chapter 11 petitions. However, if most of these businesses choose Chapter 12 instead of Chapter 11, Chapter 12 trustees will see a much heavier docket. This will necessitate the appointment of additional trustees and the hiring of staff to assist trustees in evaluating cases and providing the counseling necessary to move a small business through Chapter 12 quickly.

Respectfully submitted,

Small Business Working Group
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Prof. Edward Morrison, Co-Chair
Hon. Keith Lundin
Prof. Melissa B. Jacoby
Richardo I. Kilpatrick, Esq.
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Prof. Alan N. Resnick

[87] See text accompanying notes 35-36, *supra*.

[88] These statistics are drawn from the website of the Administrative Office of the U.S. Courts. *See* http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm.

[89] See text accompanying footnotes 27-29, *supra*.

APPENDIX

PROPOSED AMENDMENTS TO THE BANKRUPTCY CODE RELATING TO CHAPTER 12 CASES FOR SMALL BUSINESS ENTERPRISES

Change the title of Chapter 12 as follows:

Chapter 12. Adjustment of Debts of a Family Farmer ~~or Fisherman~~ , Family Fisherman, or Small Business Enterprise with Regular Annual Income

* * * *

Section 101. Definitions

* * * *

(51E) The term "small business enterprise" means a person (excluding a family farmer or family fisherman) engaged in commercial or business activities if –

(a) the person has aggregate noncontingent, liquidated secured and unsecured debts as of the order for relief in an amount not more than $10,000,000 (excluding debts owed to 1 or more affiliates or insiders); and

(b) at least 50 percent of such debts arose from the person's commercial or business activities (determined without including, if the person is an individual, any debt for the personal residence of the person or the person and spouse, unless such debt arose from the person's commercial or business activities).

* * * *

Section 104. Adjustment of Dollar Amounts

(a) On April 1, 1998, and at each 3-year interval ending on April 1 thereafter, each dollar amount in effect under sections 101(3), 101(18), 101(19A), 101(51D), 101(51E), 109(e), 303(b), 507(a), 522(d), 522(f)(3), and 522(f)(4), 522(n), 522(p), 522(q), 523(a)(2)(C), 541(b), 547(c)(9), 707(b), 1322(d), 1325(b) and 1326(b)(3) of this title and section 1409(b) of title 28 immediately before such April 1 shall be adjusted—

(1) to reflect the change in the Consumer Price Index for All Urban Consumers, published by the Department of Labor, for the most recent 3-year period ending immediately before January 1 preceding such April 1, and

(2) to round to the nearest $25 the dollar amount that represents such change.

(b) Not later than March 1, 1998, and at each 3-year interval ending on March 1 thereafter, the Judicial Conference of the United States shall publish in the Federal Register the dollar amounts that will become effective on such April 1 under sections 101(3), 101(18), 101(19A), 101(51D), 101(51E), 109(e), 303(b), 507(a), 522(d),

522(f)(3), and 522(f)(4), 522(n), 522(p), 522(q), 523(a)(2)(C), 541(b), 547(c)(9), 707(b), 1322(d), 1325(b) and 1326(b)(3) of this title and section 1409(b) of title 28.

(c) Adjustments made in accordance with paragraph (1) shall not apply with respect to cases commenced before the date of such adjustments.

* * * *

Section 109. Who May Be a Debtor

* * * *

(f) Only a family farmer, ~~or~~ family fisherman, or small business enterprise with regular annual income may be a debtor under chapter 12 of this title.

* * * *

Section 308. Debtor Reporting Requirements

(a) For purposes of this section, the term "profitability" means, with respect to a debtor, the amount of money that the debtor has earned or lost during current and recent fiscal periods.

(b) In a small business case, the debtor ~~A small business debtor~~ shall file periodic financial and other reports containing information including—

(1) the debtor's profitability;
(2) reasonable approximations of the debtor's projected cash receipts and cash disbursements over a reasonable period;
(3) comparisons of actual cash receipts and disbursements with projections in prior reports;
(4) (A) whether the debtor is—
(i) in compliance in all material respects with postpetition requirements imposed by this title and the Federal Rules of Bankruptcy Procedure; and
(ii) timely filing tax returns and other required government filings and paying taxes and other administrative expenses when due;
(B) if the debtor is not in compliance with the requirements referred to in subparagraph (A)(i) or filing tax returns and other required government filings and making the payments referred to in subparagraph (A)(ii), what the failures are and how, at what cost, and when the debtor intends to remedy such failures; and
(C) such other matters as are in the best interests of the debtor and creditors, and in the public interest in fair and efficient procedures under chapter 11 of this title.

* * * *

Section 1203. Rights and powers of debtor

(a) Subject to such limitations as the court may prescribe, a debtor in possession shall have all the rights, other than the right to compensation under section 330, and powers, and shall perform all the functions and duties, except the duties specified in paragraphs (3) and (4) of section 1106(a), of a trustee serving in a case under chapter 11, including operating the debtor's farm, commercial fishing operation, or small business enterprise's business.

(b) Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because such person

(1) was employed by or represented the debtor before the commencement of the case; or
(2) is a creditor of the debtor.

* * * *

Section 1206. Sales free of interests

After notice and a hearing, in addition to the authorization contained in section 363(f), the trustee in a case under this chapter may sell property under section 363(b) and (c) free and clear of any interest in such property of an entity other than the estate if the property is farmland, farm equipment, or property used to carry out a commercial fishing operation (including a commercial fishing vessel) or used in connection with the business of a small business enterprise, except that the proceeds of such sale shall be subject to such interest.

* * * *

Section 1209. Duties of a Debtor in a Case of a Small Business Enterprise

In a case in which the debtor is a small business enterprise, the debtor, in addition to the duties provided in this title and as otherwise required by law, shall—

(a)file with the voluntary petition --

(1)its most recent balance sheet, statement of operations, cash-flow statement, and Federal income tax return; or

(2)a statement made under penalty of perjury that no balance sheet, statement of operations, or cash-flow statement has been prepared and no Federal tax return has been filed;

(b)attend, through its senior management personnel and counsel, any meetings scheduled by the court or the United States trustee, including initial debtor

interviews and scheduling conferences, and meetings of creditors convened under section 341, unless the court, after notice and a hearing, orders otherwise;
(c)timely file all schedules and statements of financial affairs, unless the court, after notice and a hearing, grants an extension;
(d)file all postpetition financial and other reports required by the Federal Rules of Bankruptcy Procedure or by local rule of the district court;
(e)subject to section 363(c)(2), maintain insurance customary and appropriate to the debtor's business;
(f)(1) timely file tax returns and other required government filings; and
(2) subject to section 363(c)(2), timely pay all taxes entitled to administrative expense priority except those being contested by appropriate proceedings being diligently prosecuted; and
(g)allow the United States trustee, or a designated representative of the United States trustee, to inspect the debtor's business premises, books, and records at reasonable times, after reasonable prior written notice, unless notice is waived by the debtor.
(h)file periodic financial and other reports containing information including –
(1) the amount of money that the debtor has earned or lost during the current and recent fiscal periods;
(2) reasonable approximations of the debtor's projected cash receipts and cash disbursements over a reasonable period;
(3) comparisons of actual cash receipts and disbursements with projections in prior reports;
(4) (A) whether the debtor is—
(i)in compliance in all material respects with postpetition requirements imposed by this title and the Federal Rules of Bankruptcy Procedure; and
(ii)timely filing tax returns and other required government filings and paying taxes and other administrative expenses when due; and
(B) if the debtor is not in compliance with the requirements referred to in subparagraph (A)(i) or filing tax returns and other required government filings and making the payments referred to in subparagraph (A)(ii), what the failures are and how, at what cost, and when the debtor intends to remedy such failures.

* * * *

Section 1228. Discharge

(a) Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan or, in a case in which the debtor is a small business enterprise, at such earlier time on or after the date on which the plan is confirmed as the court after notice and a hearing orders for cause, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are

due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid, other than payments to holders of allowed claims provided for under section 1222(b)(5) or 1222(b)(9) of this title, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan allowed under section 503 of this title or disallowed under section 502 of this title, except any debt—
(1) provided for under section 1222(b)(5) or 1222(b)(9) of this title; or
(2) of the kind specified in section 523(a) of this title.

*** * * ***

Effective Date; Application of Amendments [Non-Codified Provision]

(a) EFFECTIVE DATE – Except as provided in subsection (b) and (c), this Act and the amendments made by this Act shall take effect 30 days after the date of enactment of this Act.
(b) APPLICATION OF AMENDMENTS – The amendments made by this Act shall not apply with respect to cases commenced under title 11, United States Code, before the effective date of this Act.
(c) CONVERSION OF SMALL BUSINESS CASES TO CHAPTER 12 – Small business cases commenced under title 11, United States Code, before the effective date of this Act may not be converted to a case under chapter 12 of title 11 unless the debtor is a family farmer or family fisherman with regular annual income.

Absolute Priority

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Friday, May 29, 2015

10:20 a.m.-11:20 a.m.

Hon. Thomas L. Ambro
Prof. Douglas G. Baird
Corrinne Ball

Absolute Priority and Departures from Bankruptcy's Distributional Rules

Douglas G. Baird

The modern law of corporate reorganizations begins with *Northern Pacific Railway Co. v. Boyd*.[1] A creditor who was not given the chance to participate in the reorganization process argued that the plan of reorganization could not allow old shareholders to remain in place and at the same time extinguish his rights as a general creditor. The Supreme Court held that a complete freeze-out of an intervening creditor was not permitted.[2]

It was not enough for the senior creditor to show that it was owed more than the company was worth. As the Court explained, "the question must be decided according to a fixed principle, not leaving the rights of the creditors to depend upon the balancing of evidence."[3] The Court did not explain this "fixed principle" in any detail. To many practitioners and academics, *Boyd* establishes the idea that bankruptcy must adhere to its distributional rules. One can locate the principle explicit in the "fair and equitable" and "unfair discrimination" language of §1129(b), the distributional priorities of §507, the pro rata sharing rule of §726(b), and it may be present in other parts of the Bankruptcy Code as well.

A fundamental question of bankruptcy reform is the extent to which bankruptcy judges should be bound to adhere to a "fixed principle" of distribution or whether some departure is possible when the facts are sufficiently compelling. The problem arises in many guises, most recently in the Third Circuit's opinion last week in *In re Jevic Holding Corp*.[4]

I.

The question of the extent to which the distributional rules of the Bankruptcy Code are inviolate arises most obviously when courts confront the question whether "gifts" are permissible, whether a senior creditor who is

[1] 228 U.S. 482 (1913). For two excellent accounts of *Boyd* and the evolution of the absolute priority rule, see John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 MICH. L. REV. 963 (1989); Randolph J. Haines, *The Unwarranted Attack on New Value*, 72 AM. BANKR. L.J. 387 (1998).

[2] *See Boyd*, 228 U.S. at 504–05.

[3] *Id.* at 507.

[4] ••• F.3d ••• (3d Cir. 2015).

owed more than the firm is worth to give up a portion of her own share and transfer it to a junior investor.[5] Consider the facts of *In re Journal Register Co*.[6]

Formally established in 1997, Journal Register was a national media company that owned and operated twenty daily newspapers, fourteen printing facilities, and hundreds of non-daily publications and local news and information websites. It owed its secured lender nearly $700 million, a group of unsecured creditors about $20 million, and its trade creditors about $7 million. The company was worth less than half of what the secured creditors were owed. The secured creditors backed a plan in which they recovered only about forty cents on the dollar and gave garden-variety unsecured creditors about ten cents on the dollar. Trade creditors were paid in full.

The general creditors were not entitled to anything under the absolute priority rule, given the haircut the secureds were taking. But the plan contemplated paying the trade creditors much more than other unsecured creditors who possessed identical legal rights. This favoritism, some of the unsecured creditors argued, prevented the offer to them from being "the fair offer" that *Boyd* mandated.[7] They conceded that the secured creditor did not have to give any distribution to junior creditors, but they argued that, if the secured creditor wanted to do so, it was not free to pick and choose.

The law of corporate reorganizations operated on "a fixed principle." If the secured creditor liquidated the business, it might be able to do what it pleased, but if it called on a court of equity to assist, equity had to be done. Similarly situated creditors must be treated the same, unless they consented to different treatment. The court found that this plan could be confirmed, but it relied heavily on the idea embedded in §1129 that a class of affected creditors can bind a dissenting minority. In this case, the vast majority of the unsecured creditors not receiving the gift supported the plan. This was enough to justify a departure from bankruptcy's distributional rules.

But consider whether things would be different if the affected class dissented. If the trade creditors were put in one class and the other general creditors were in another, and the general creditors as a class objected, could the court still confirm? The technical question under existing law is whether the plan "unfairly discriminates" against one class of unsecured creditors.

[5] For an overview of gifting, see Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 AM. BANKR. L.J. 663, 710–13 (2009).

[6] 407 Bankr. 520 (Bankr. S.D.N.Y. 2009).

[7] *Id.* at 529.

It might seem that *Dish Network Corp. v. DBSD, North America, Inc. (In re DBSD, North America, Inc.)*[8] settles this question and prohibits such a gift. Paying cents on the dollar to some general creditors while paying others in full is "unfair discrimination," even when value is purportedly coming from a more senior creditor.

ICO Global Communications founded DBSD in 2004 to develop a mobile communications network that would use both satellites and land-based transmission towers. In its first five years, DBSD made progress toward this goal, successfully launching a satellite and obtaining certain spectrum licenses from the FCC, but it also accumulated a large amount of debt. Because its network had not become operational, DBSD had insufficient revenue to service its debt.

The senior lenders negotiated a deal with ICO, in which they would receive new notes and the bulk of the equity in the reorganized firm, worth between half and three-quarters of the amount they were owed. Unsecured creditors would receive a small slice of the equity, and ICO itself would receive both shares and warrants. ICO filed for bankruptcy and sought to confirm this plan. One of the unsecured creditors objected. The Second Circuit held that this plan violated the rule of *Boyd* and refused to confirm it.[9]

DBSD, however, is not necessarily inconsistent with upholding a plan under the facts of *Journal Register* even when an impaired class objects. The rationale for the gift in the latter case was that it would ensure the goodwill of the trade creditors.[10] Indeed, the plan proponents urged the court that the payment was essential to the long-term survival of the debtors' business.

Unlike the payment in *DBSD*, the gift in *Journal Register* was part of a plan to publish newspapers going forward. The gift was not part of an effort to capture players who controlled the process and push through a plan. The gift did not freeze out the unsecured creditors or prevent them from participating in the process. Paying trade creditors was simply a self-interested calculation on the part of the new owners of the business that its company was better off paying them than not. Treating them as if the bankruptcy never happened was just good business.

[8] 634 F.3d 79 (2d Cir. 2010).

[9] *Id.* at 100–01 ("although Congress did soften the absolute priority rule in some ways, it did not create any exception for 'gifts' like the one at issue here").

[10] *Journal Register*, 407 Bankr. at 534 (concluding that "the Creditors Committee acted appropriately and ably in these cases and that the "gift" is not being made for ulterior purposes").

This is altogether different from the dynamic in *DBSD*. The shareholders in *DBSD* were not diverse public shareholders with no role in running the affairs of the company. Rather, they had formed a holding company that completely controlled the debtor. It is possible to characterize the "gift" in that case as the price that those controlling the debtor (and hence the reorganization process) could demand in advance of the filing for supporting the plan of reorganization. The shareholders had a fiduciary duty in exercising their control that ran to all the investors in the firm. They were not being paid for any future value or services they might contribute to the business; on the contrary, they were being paid for putting in place a reorganization plan that one set of investors wanted to implement at the expense of others.

Members of the board have a duty of loyalty. That the action in question (a plan that otherwise comports with the absolute priority rule) is sensible is not the point. Directors are supposed to make independent decisions and are not supposed to accept any payoffs in the course of doing the right thing. The anti-gifting rule is a prophylactic rule that nips such mischief in the bud. It aims at ensuring that the plan-formation process is squeaky clean. As the Second Circuit put it, "if the parties here were less scrupulous or the bankruptcy court less vigilant, a weakened absolute priority rule could allow for serious mischief between senior creditors and existing shareholders."[11] In the course of bargaining with the debtor in advance of bankruptcy, creditors can negotiate with those who control the reorganization process, but they cannot bribe them.

DBSD does not stand necessarily for an absolute prohibition against gifting in cases such as *Journal Register*.[12] In those cases in which the payment looks more like a sensible business decision and less like a bribe, gifts may be permissible, even when they are part of the reorganization plan and even when they go to an equityholder. A senior creditor, for example, might provide for a "gift" of equity to the founder of the company as part of a package that ensures that she remains with the business.

Some have suggested that there are ways in which parties can avoid the strict letter of the holding of *DBSD* by ensuring that the gift is not formally

[11] *DBSD*, 634 F.3d at 100.

[12] For the argument that *DBSD* put an end to interclass gifting, see Stephen J. Lubben, *Ruling Appears to End Chapter 11 "Gift" Plans*, THE NEW YORK TIMES DEAL BOOK (February 8, 2011), http://dealbook.nytimes.com/2011/02/08/ruling-appears-to-end-to-chapter-11-gift-plans/.

part of the plan of the reorganization.[13] For example, instead of the plan providing for equity to the old shareholder, it could be provided to her as part of a new retention agreement between her and the reorganized firm. Alternatively, instead of a plan of reorganization, the assets could be sold in a §363 sale to the old lender.[14] In its capacity as buyer of the assets, the senior lender could give the old equityholder whatever it wanted. Under this arrangement, the gift is not from a senior creditor to an equityholder under a plan, but rather it is by a third party completely unconnected with the reorganization.

It is not at all clear, however, that such devices will work. It is not obvious that such gifts can be "outside" the plan.[15] Parties are always ill-advised to keep the judge or other parties in the dark about such matters. It is going to be hard for the disclosure statement and any plan accompanying it to avoid mention of any gifts, and once they are mentioned, it is hard to argue they are "outside" the plan of reorganization. The anti-gifting doctrine is a direct descendant of fraudulent conveyance law, a doctrine that always looks to substance rather than form.[16]

More fundamentally, focusing narrowly on the requirements of §1129 and its formal dictates obscures the more fundamental question of the extent to which bankruptcy's distributional rules, including its pro rata sharing rules, are themselves "fixed principles" that put hard boundaries on the

[13] *See* Marc Abrams & Ana Alfonso, *Second Circuit Court of Appeals Holds "Gift" from Secured Creditor to Shareholder Under a Chapter 11 Plan Violates Absolute Priority Rule*, THE METROPOLITAN CORPORATE COUNSEL 46 (April 2011), http://www.willkie.com/firm/pubs_results.aspx?Departments=324490805.

[14] *See* Michael Friedman & Keith N. Sambur, *"DBSD": Has Confirming a Plan Become More Difficult?*, 245 NEW YORK LAW JOURNAL (May 12, 2011), http://www.rkollp.com/newsroom-publications-154.html ("Another possible solution would be to implement the gift in connection with a sale of all or substantially all of a debtor's assets pursuant to Bankruptcy Code §363.").

[15] *See* Ralph Brubaker, *Taking Chapter 11's Distribution Rules Seriously: "Inter-Class Gifting is Dead! Long Live Inter-Class Gifting!"*, 31 BANKR. LAW LETTER 1 (2011), ("When the inter-class 'gift' is effectuated outside the context of a plan of reorganization, the extent to which the absolute priority rule and other plan distribution constraints are applicable, if at all, is highly uncertain.").

[16] *See, e.g.*, Orr v. Kinderhill Corp., 991 F.2d 31 (2d Cir. 1993).

ability of the bankruptcy judge to exercise her equitable powers. The Third Circuit's opinion in *In re Jevic* illustrates.[17]

II.

Jevic Transportation ceased operations without any advance notice to its workers and then filed a Chapter 11 petition. By the time the Chapter 11 had run its course, the debtor had only $1.7 million left, all of which was subject to the lien of two secured creditors, one of which was the private equity investor. The creditors' committee brought a fraudulent conveyance and preference action against the two secured creditors and survived a motion to dismiss.

A round of settlement negotiations ensued, and an agreement was reached. One of the secured creditors put $2 million into a fund to pay the debtor's and the committee's fees and other administrative expenses. The remaining $1.7 million that was subject to liens was placed into a trust to pay tax and administrative claims and then general unsecured creditors. Finally, the case would be dismissed.

Left out of the bargain were the WARN Act claims of the workers, claims they asserted against both the debtor and the private equity fund. Most of these were priority wage claims that would ordinarily prime the claims of ordinary unsecured creditors. Because the funds were placed into the trust, the general creditors received funds that, had they been in the estate, would have gone to the truckers.

It seems that the truckers were unable to settle the WARN Act claims because the private equity fund (which was also a secured creditor) was unwilling to join a settlement that put funds at the disposal of an illiquid party bent on litigation against it. As its counsel explained, "If the money goes to the WARN plaintiffs, then you're funding someone who is suing you who otherwise doesn't have funds."

The bankruptcy judge approved a structured dismissal that included a distribution of assets inconsistent with the priorities in §507. No plan of reorganization was in prospect and there was no chance of any distribution if the case were converted to Chapter 7. In the absence of this settlement, the bankruptcy judge was convinced that no one other than the secured creditors would receive anything. No one would bring a fraudulent conveyance

[17] Official Committee of Unsecured Creditors v. CIT Group/Business Inc., xxx F.3d xxx (3d Cir. 2015). The question of the relationship between gifts and the absolute priority rule also arose in In re Iridium Operating LLC, 478 F.3d 452 (2d Cir. 2007).

action on a contingent-fee basis. As the bankruptcy judge explained, "any lawyer or firm that signed up for that role should have his head examined." In approving the settlement, he was deciding on a course that left unsecured creditors with either "a meaningful return or zero."

The Third Circuit held that a settlement that is inconsistent with bankruptcy's priority rules is "likely to be justified only rarely." It nevertheless affirmed, over a dissent, finding that the Code permits a structured dismissal when "the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors." By approving the structured dismissal, the bankruptcy judge made some creditors better off without making anyone else worse off.

But we always need to worry that mischief may be going on beneath the surface. Consider the following. Debtor owes Senior Lender $50 million. Uncontroverted expert testimony shows that Debtor is worth less than $50 million. Debtor has both institutional debt and trade debt; all of it is unsecured. The institutional debt, amounting to about half of the debt of Debtor, is held by five sophisticated and aggressive hedge funds based in the Southern District of New York. The trade debt, also amounting to about half the debt of Debtor, is dispersed among hundreds of mom-and-pop suppliers. Some live in Peoria, but most are located in smaller, more rural, towns.

The trade creditors are not active in the case, but the hedge funds make noises about the validity of Senior Lender's liens. These, however, become muted once plan negotiations start in earnest. Debtor puts forward a plan, supported by Senior Lender and the hedge funds. Senior Lender receives all the equity of the reorganized debtor. All the unsecured creditors are paid 5 cents on the dollar. In a side deal, Senior Lender promises to give each of the hedge funds a 40-cents-per-dollar premium.

In substance, the hedge funds have settled an avoidance action and captured the proceeds for themselves. When seen together with the side-payment, the plan violates Bankruptcy Code's pro-rata sharing principle. One might argue that such a plan should not be confirmed even if the trade creditors were in a class by themselves and consented to the plan. Bankruptcy is designed so that the most active and vigilant creditors protect others at the same priority level. Side payments are objectionable even when other rules are satisfied. When the hedge funds challenge the validity of the liens, all the general creditors should benefit.

IV.

One can argue that a fixed principle that insists on strict adherence to bankruptcy's distributional rules is a sensible prophylactic rule. It ensures that the active creditors are unable to divert avoidance recoveries and other

benefits for themselves at the expense of the less sophisticated. Handcuffing the judge, however, comes at a cost.

Consider the following hypothetical.[18] The debtor is a steel mill that has ceased operations. The only tangible asset with any value is a large quantity of steel ingots. They have a market value of $75. The debtor also acquired a put on the ingot. It has entered a contract in which a third party is obliged to pay $125 for the ingots if delivered within a week's time. The general creditors as a group are owed hundreds. The workers are owed $10. The workers have put up a picket line and hire a lawyer to represent them. The lawyer is nicknamed "Fast Eddie." In addition to practicing law, he is one of the most powerful politicians in the city and has excellent relations with the city police and virtually everyone else.

Fast Eddie listens patiently as the debtor talks about its difficulties. The police, it appears, seem unusually reluctant to protect anyone who might try to cross the picket line in the absence of police protection. Because of the Norris-LaGuardia Act, the court lacks the power to order the picket line removed. Fast Eddie is completely sympathetic with the debtor's plight, but he expresses some sympathy for the position of the workers, who not only are owed $10, but now must pay his rather substantial fees as well.

Fast Eddie expresses his hope that the debtor will find a way to do the right thing, pointing out that the debtor's investors might have trouble doing business in the city with new ventures if things cannot be worked out. The workers, after all, only want what is reasonable. After several false starts, the debtor asks if $15 is "reasonable," and Fast Eddie implies that it is. Should a bankruptcy judge approve the payment? If it is approved, the workers are paid in full and Eddie is paid his generous fee. Such a deal appears inconsistent with bankruptcy's distributional rules. The workers are not entitled to be paid 100 cents on the dollar. Eddie's fee is not even a claim.

But one can argue that striking some sort of deal is in everyone's interest. Fast Eddie's threat to keep the picket line in place is credible. The workers have nothing to lose by keeping the picket line in place. The steel mill is shutting down and they will receive virtually nothing even if the option is exercised. Moreover, Fast Eddie has a reputation for carrying out his threats. He is better off receiving nothing in this case than compromising his reputation for tough dealing in the future. The rest of the creditors receive more if they cut a deal than if they do not.

[18] These facts are loosely based on In re EDC Holding Co., 676 F.2d 945 (7th Cir. 1982).

Cases can arise in which adhering to bankruptcy's distributional rules reduces the total amount creditors receive. Consider the following. Firm owes its trade creditors $2 and its other general creditors $8. All agree on an auction of the firm's assets. Two buyers appear. Both intend to fold the firm's operations into their own. Exactly the same number of jobs will be preserved in either event. Buyer One has ongoing dealings with the trade creditors. As a matter of good business, it plans on paying the trade creditors in full. Buyer Two has no relationship with the trade creditors and does not plan on paying them anything. Buyer Two bids $3. Buyer One bids $2 in addition to the $2 it will give to the trade creditors.

Which bid should be accepted? The total distribution to the creditors as a group is maximized if Buyer One's bid is accepted. (There is a total payout of $4, with the trade being paid in full and the other general creditors receiving 25 cents on the dollar.) On the other hand, the value of the estate is maximized and the payout of those with claims against its assets is maximized if Buyer Two's bid is accepted. (There are $10 in claims and $3 in proceeds of the sale. Claimants against the estate, including the trade creditors, receive 30 cents on the dollar.)

The same tension exists even when the two deals on the table makes one party better off and leaves the other no worse off. Buyer One and Buyer Two bid the same amount, but Buyer One will pay the trade creditors and Buyer Two will not. It might seem that one should not object to payments to trade creditors. The general creditors would not receive anything even if Buyer Two's bid were accepted. One can argue that these are the facts of *Jevic*. There was no alternative path that would have provided any payout to the truckers.

In the absence of any alternative that would offer a distribution to anyone, following a path that would leave some creditors with something might not seem objectionable. The difficulty, however, is the one that we have encountered in multiple guises. One must always worry about the motive that led to the distribution to the favored creditors. Those responsible for giving value to creditors who are otherwise out of the money are rarely acting out of sympathy or feelings of charity. In some cases, such as *Journal Register*, the motive will be innocent and the absence of mischief plain, but this will not always be the case.

V.

Cases such as *In re Jevic* show able bankruptcy judges making the best of a bad situation. At the same time, the dissent in *Jevic* explains why there is cause for concern nevertheless. In the end, one must focus squarely on why there is a departure from bankruptcy's distributional rules. Such departures

can distort the process and encourage bad behavior in future cases. Limiting the bankruptcy judge's ability to depart from them nips such mischief in the bud, but at the cost of preventing bargains (even unsavory ones with characters such as Fast Eddie) that make everyone collectively better off. Front and center of bankruptcy reform should be the question of the extent to which there should be a "fixed principle" of distribution that limits the discretion of the bankruptcy judge.

PRECEDENTIAL

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 14-1465

In re: JEVIC HOLDING CORP., et al.,

Debtors

OFFICIAL COMMITTEE OF UNSECURED CREDITORS
on behalf of the bankruptcy estates
of Jevic Holding Corp., et al.

v.

CIT GROUP/BUSINESS CREDIT INC.,
in its capacity as Agent;
SUN CAPITAL PARTNERS, INC.;
SUN CAPITAL PARTNERS IV, LP;
SUN CAPITAL PARTNERS MANAGEMENT IV, LLC

CASIMIR CZYZEWSKI; MELVIN L. MYERS;
JEFFREY OEHLERS; ARTHUR E. PERIGARD
and DANIEL C. RICHARDS,
on behalf of themselves and all others similarly situated,

Appellants

On Appeal from the United States District Court
for the District of Delaware
(D.C. Nos. 13-cv-00104 & 1-13-cv-00105)
District Judge: Honorable Sue L. Robinson

Argued January 14, 2015

Before: HARDIMAN, SCIRICA and BARRY,
Circuit Judges

(Filed: May 21, 2015)

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OPINION OF THE COURT

HARDIMAN, Circuit Judge

This appeal raises a novel question of bankruptcy law: may a case arising under Chapter 11 ever be resolved in a

"structured dismissal" that deviates from the Bankruptcy Code's priority system? We hold that, in a rare case, it may.

I

A

Jevic Transportation, Inc. was a trucking company headquartered in New Jersey. In 2006, after Jevic's business began to decline, a subsidiary of the private equity firm Sun Capital Partners acquired the company in a leveraged buyout financed by a group of lenders led by CIT Group. The buyout entailed the extension of an $85 million revolving credit facility by CIT to Jevic, which Jevic could access as long as it maintained at least $5 million in assets and collateral. The company continued to struggle in the two years that followed, however, and had to reach a forbearance agreement with CIT—which included a $2 million guarantee by Sun—to prevent CIT from foreclosing on the assets securing the loans. By May 2008, with the company's performance stagnant and the expiration of the forbearance agreement looming, Jevic's board of directors authorized a bankruptcy filing. The company ceased substantially all of its operations, and its employees received notice of their impending terminations on May 19, 2008.

The next day, Jevic filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the District of Delaware. At that point, Jevic owed about $53 million to its first-priority senior secured creditors (CIT and Sun) and over $20 million to its tax and general unsecured creditors. In June 2008, an Official Committee of Unsecured Creditors (Committee) was appointed to represent the unsecured creditors.

This appeal stems from two lawsuits that were filed in the Bankruptcy Court during those proceedings. First, a group of Jevic's terminated truck drivers (Drivers) filed a class action against Jevic and Sun alleging violations of federal and state Worker Adjustment and Retraining Notification (WARN) Acts, under which Jevic was required to provide 60 days' written notice to its employees before laying them off. *See* 29 U.S.C. § 2102; N.J. Stat. Ann. § 34:21-2. Meanwhile, the Committee brought a fraudulent conveyance action against CIT and Sun on the estate's behalf, alleging that Sun, with CIT's assistance, "acquired Jevic with virtually none of its own money based on baseless projections of almost immediate growth and increasing profitability." App. 770 (Second Am. Compl. ¶ 1). The Committee claimed that the ill-advised leveraged buyout had hastened Jevic's bankruptcy by saddling it with debts that it couldn't service and described Jevic's demise as "the foreseeable end of a reckless course of action in which Sun and CIT bore no risk but all other constituents did." App. 794 (Second Am. Compl. ¶ 128).

Almost three years after the Committee sued CIT and Sun for fraudulent conveyance, the Bankruptcy Court granted in part and denied in part CIT's motion to dismiss the case. The Court held that the Committee had adequately pleaded claims of fraudulent transfer and preferential transfer under 11 U.S.C. §§ 548 and 547. Noting the "great potential for abuse" in leveraged buyouts, the Court concluded that the Committee had sufficiently alleged that CIT had played a critical role in facilitating a series of transactions that recklessly reduced Jevic's equity, increased its debt, and shifted the risk of loss to its other creditors. *In re Jevic Holding Corp.*, 2011 WL 4345204, at *10 (Bankr. D. Del. Sept. 15, 2011) (quoting *Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056, 1073 (3d Cir. 1992)). The Court dismissed

without prejudice the Committee's claims for fraudulent transfer under 11 U.S.C. § 544, for equitable subordination of CIT's claims against the estate, and for aiding and abetting Jevic's officers and directors in breaching their fiduciary duties, because the Committee's allegations in support of these claims were too sparse and vague.

In March 2012, representatives of all the major players—the Committee, CIT, Sun, the Drivers, and what was left of Jevic—convened to negotiate a settlement of the Committee's fraudulent conveyance suit. By that time, Jevic's only remaining assets were $1.7 million in cash (which was subject to Sun's lien) and the action against CIT and Sun. All of Jevic's tangible assets had been liquidated to repay the lender group led by CIT. According to testimony in the Bankruptcy Court, the Committee determined that a settlement ensuring "a modest distribution to unsecured creditors" was desirable in light of "the risk and the [re]wards of litigation, including the prospect of waiting for perhaps many years before a litigation against Sun and CIT could be resolved" and the lack of estate funds sufficient to finance that litigation. App. 1275.

In the end, the Committee, Jevic, CIT, and Sun reached a settlement agreement that accomplished four things. First, those parties would exchange releases of their claims against each other and the fraudulent conveyance action would be dismissed with prejudice. Second, CIT would pay $2 million into an account earmarked to pay Jevic's and the Committee's legal fees and other administrative expenses. Third, Sun would assign its lien on Jevic's remaining $1.7 million to a trust, which would pay tax and administrative creditors first and then the general unsecured creditors on a

pro rata basis.[1] Lastly, Jevic's Chapter 11 case would be dismissed. The parties' settlement thus contemplated a structured dismissal, a disposition that winds up the bankruptcy with certain conditions attached instead of simply dismissing the case and restoring the status quo ante. *See In re Strategic Labor, Inc.*, 467 B.R. 11, 17 n.10 (Bankr. D. Mass. 2012) ("Unlike the old-fashioned one sentence dismissal orders—'this case is hereby dismissed'—structured dismissal orders often include some or all of the following additional provisions: 'releases (some more limited than others), protocols for reconciling and paying claims, "gifting" of funds to unsecured creditors[, etc.]'" (citation omitted)).

There was just one problem with the settlement: it left out the Drivers, even though they had an uncontested WARN Act claim against Jevic.[2] The Drivers never got the chance to present a damages case in the Bankruptcy Court, but they estimate their claim to have been worth $12,400,000, of

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[1] This component of the agreement originally would have paid all $1.7 million to the general unsecured creditors, but the United States Trustee, certain priority tax creditors, and the Drivers objected. The general unsecured creditors ultimately received almost four percent of their claims under the settlement.

[2] Although Sun was eventually granted summary judgment in the WARN Act litigation because it did not qualify as an employer of the Drivers, *In re Jevic Holding Corp.*, 492 B.R. 416, 425 (Bankr. D. Del. 2013), the Bankruptcy Court entered summary judgment against Jevic because it had "undisputed[ly]" violated the state WARN Act, *In re Jevic Holding Corp.*, 496 B.R. 151, 165 (Bankr. D. Del. 2013).

which $8,300,000 was a priority wage claim under 11 U.S.C. § 507(a)(4). *See* Drivers' Br. 6 & n.3; *In re Powermate Holding Corp.*, 394 B.R. 765, 773 (Bankr. D. Del. 2008) ("Courts have consistently held that WARN Act damages are within 'the nature of wages' for which § 507(a)(4) provides."). The record is not explicit as to why the settlement did not provide for any payment to the Drivers even though they held claims of higher priority than the tax and trade creditors' claims.[3] It seems that the Drivers and the other parties were unable to agree on a settlement of the WARN Act claim, and Sun was unwilling to pay the Drivers as long as the WARN Act lawsuit continued because Sun was a defendant in those proceedings and did not want to fund litigation against itself.[4] The settling parties also accept the

[3] For example, Jevic's chief restructuring officer opaquely testified in the Bankruptcy Court: "There was no decision not to pay the WARN claimants. There was a decision to settle certain proceedings amongst parties. The WARN claimants were part of that group of people that decided to create a settlement. So there was no decision not to pay the WARN claimants." App. 1258.

[4] Sun's counsel acknowledged as much in the Bankruptcy Court, stating:

> [I]t doesn't take testimony for Your Honor . . . to figure out, Sun probably does care where the money goes because you can take judicial notice that there's a pending WARN action against Sun by the WARN plaintiffs. And if the money goes to the WARN plaintiffs, then you're funding somebody who is suing you who

Drivers' contention that it was "the paramount interest of the Committee to negotiate a deal under which the [Drivers] were excluded" because a settlement that paid the Drivers' priority claim would have left the Committee's constituents with nothing. Appellees' Br. 26 (quoting Drivers' Br. 28).

B

The Drivers and the United States Trustee objected to the proposed settlement and dismissal mainly because it distributed property of the estate to creditors of lower priority than the Drivers under § 507 of the Bankruptcy Code. The Trustee also objected on the ground that the Code does not permit structured dismissals, while the Drivers further argued that the Committee breached its fiduciary duty to the estate by "agreeing to a settlement that, effectively, freezes out the [Drivers]." App. 30–31 (Bankr. Op. 8–9). The Bankruptcy Court rejected these objections in an oral opinion approving the proposed settlement and dismissal.

The Bankruptcy Court began by recognizing the absence of any "provision in the code for distribution and dismissal contemplated by the settlement motion," but it noted that similar relief has been granted by other courts. App. 31 (Bankr. Op. 9). Summarizing its assessment, the

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> otherwise doesn't have funds and is doing it on a contingent fee basis.

App. 1363; *accord* Appellees' Br. 26. This is the only reason that appears in the record for why the settlement did not provide for either direct payment to the Drivers or the assignment of Sun's lien on Jevic's remaining cash to the estate rather than to a liquidating trust earmarked for everybody but the Drivers.

Court found that "the dire circumstances that are present in this case warrant the relief requested here by the Debtor, the Committee and the secured lenders." *Id.* The Court went on to make findings establishing those dire circumstances. It found that there was "no realistic prospect" of a meaningful distribution to anyone but the secured creditors unless the settlement were approved because the traditional routes out of Chapter 11 bankruptcy were impracticable. App. 32 (Bankr. Op. 10). First, there was "no prospect" of a confirmable Chapter 11 plan of reorganization or liquidation being filed. *Id.* Second, conversion to liquidation under Chapter 7 of the Bankruptcy Code would have been unavailing for any party because a Chapter 7 trustee would not have had sufficient funds "to operate, investigate or litigate" (since all the cash left in the estate was encumbered) and the secured creditors had "stated unequivocally and credibly that they would not do this deal in a Chapter 7." *Id.*

The Bankruptcy Court then rejected the objectors' argument that the settlement could not be approved because it distributed estate assets in violation of the Code's "absolute priority rule." After noting that Chapter 11 plans must comply with the Code's priority scheme, the Court held that settlements need not do so. The Court also disagreed with the Drivers' fiduciary duty argument, dismissing the notion that the Committee's fiduciary duty to the estate gave each creditor veto power over any proposed settlement. The Drivers were never barred from participating in the settlement negotiations, the Court observed, and their omission from the settlement distribution would not prejudice them because their claims against the Jevic estate were "effectively worthless" since the estate lacked any unencumbered funds. App. 36 (Bankr. Op. 14).

Finally, the Bankruptcy Court applied the multifactor test of *In re Martin*, 91 F.3d 389 (3d Cir. 1996), for evaluating settlements under Federal Rule of Bankruptcy Procedure 9019. It found that the Committee's likelihood of success in the fraudulent conveyance action was "uncertain at best," given the legal hurdles to recovery, the substantial resources of CIT and Sun, and the scarcity of funds in the estate to finance further litigation. App. 34–35 (Bankr. Op. 12–13). The Court highlighted the complexity of the litigation and expressed its skepticism that new counsel or a Chapter 7 trustee could be retained to continue the fraudulent conveyance suit on a contingent fee basis. App. 35–36 (Bankr. Op. 13–14) ("[O]n these facts I think any lawyer or firm that signed up for that role should have his head examined."). Faced with, in its view, either "a meaningful return or zero," the Court decided that "[t]he paramount interest of the creditors mandates approval of the settlement" and nothing in the Bankruptcy Code dictated otherwise. App. 36 (Bankr. Op. 14). The Bankruptcy Court therefore approved the settlement and dismissed Jevic's Chapter 11 case.

C

The Drivers appealed to the United States District Court for the District of Delaware and filed a motion in the Bankruptcy Court to stay its order pending appeal. The Bankruptcy Court denied the stay request, and the Drivers did not renew their request for a stay before the District Court. The parties began implementing the settlement months later, distributing over one thousand checks to priority tax creditors and general unsecured creditors.

The District Court subsequently affirmed the Bankruptcy Court's approval of the settlement and dismissal of the case. The Court began by noting that the Drivers

"largely do not contest the bankruptcy court's factual findings." *Jevic Holding Corp.*, 2014 WL 268613, at *2 (D. Del. Jan. 24, 2014). In analyzing those factual findings, the District Court held, the Bankruptcy Court had correctly applied the *Martin* factors and determined that the proposed settlement was "fair and equitable." *Id.* at *2–3. The Court also rejected the Drivers' fiduciary duty and absolute priority rule arguments for the same reasons explained by the bankruptcy judge. *Id.* at *3. And even if the Bankruptcy Court had erred by approving the settlement and dismissing the case, the District Court held in the alternative that the appeal was equitably moot because the settlement had been "substantially consummated as all the funds have been distributed." *Id.* at *4. The Drivers filed this timely appeal, with the United States Trustee supporting them as amicus curiae.

II

The Bankruptcy Court had jurisdiction under 28 U.S.C. § 157(b), and the District Court had jurisdiction under 28 U.S.C. §§ 158(a) and 1334. We have jurisdiction under 28 U.S.C. §§ 158(d) and 1291.

"Because the District Court sat below as an appellate court, this Court conducts the same review of the Bankruptcy Court's order as did the District Court." *In re Telegroup, Inc.*, 281 F.3d 133, 136 (3d Cir. 2002). We review questions of law de novo, findings of fact for clear error, and exercises of discretion for abuse thereof. *In re Goody's Family Clothing Inc.*, 610 F.3d 812, 816 (3d Cir. 2010).

III

To the extent that the Bankruptcy Court had discretion to approve the structured dismissal at issue, the Drivers tacitly concede that the Court did not abuse that discretion in approving a settlement of the Committee's action against CIT and Sun and dismissing Jevic's Chapter 11 case.

First, Federal Rule of Bankruptcy Procedure 9019 expressly authorizes settlements as long as they are "fair and equitable." *Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson* (*TMT Trailer Ferry*), 390 U.S. 414, 424 (1968). In *Martin*, we gleaned from *TMT Trailer Ferry* four factors to guide bankruptcy courts in this regard: "(1) the probability of success in litigation; (2) the likely difficulties in collection; (3) the complexity of the litigation involved, and the expense, inconvenience and delay necessarily attending it; and (4) the paramount interest of the creditors." 91 F.3d at 393. None of the objectors contends that the Bankruptcy Court erred in concluding that the balance of these factors favors settlement, and we agree. Although the Committee's fraudulent conveyance suit survived a motion to dismiss, it was far from compelling, especially in view of CIT's and Sun's substantial resources and the Committee's lack thereof. App. 35 (Bankr. Op. 13); *see* App. 1273 (summarizing expert testimony CIT planned to offer that Jevic's failure was caused by systemic economic and industrial problems, not the leveraged buyout); *In re World Health Alts., Inc.*, 344 B.R. 291, 302 (Bankr. D. Del. 2006) ("[S]uccessful challenges to a pre-petition first lien creditor's position are unusual, if not rare."). The litigation promised to be complex and lengthy, whereas the settlement offered most of Jevic's creditors actual distributions.

Nor do the Drivers dispute that the Bankruptcy Court generally followed the law with respect to dismissal. A bankruptcy court may dismiss a Chapter 11 case "for cause," and one form of cause contemplated by the Bankruptcy Code is "substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation[.]" 11 U.S.C. § 1112(b)(1), (b)(4)(A). By the time the settling parties requested dismissal, the estate was almost entirely depleted and there was no chance of a plan of reorganization being confirmed. But for $1.7 million in encumbered cash and the fraudulent conveyance action, Jevic had nothing.

Instead of challenging the Bankruptcy Court's discretionary judgments as to the propriety of a settlement and dismissal, the Drivers and the United States Trustee argue that the Bankruptcy Court did not have the discretion it purported to exercise. Specifically, they claim bankruptcy courts have no legal authority to approve structured dismissals, at least to the extent they deviate from the priority system of the Bankruptcy Code in distributing estate assets. We disagree and hold that bankruptcy courts may, in rare instances like this one, approve structured dismissals that do not strictly adhere to the Bankruptcy Code's priority scheme.

A

We begin by considering whether structured dismissals are ever permissible under the Bankruptcy Code. The Drivers submit that "Chapter 11 provides debtors only three exits from bankruptcy": confirmation of a plan of reorganization, conversion to Chapter 7 liquidation, or plain dismissal with no strings attached. Drivers' Br. 18. They argue that there is no statutory authority for structured dismissals and that "[t]he Bankruptcy Court admitted as much." *Id.* at 44. They cite a

provision of the Code and accompanying legislative history indicating that Congress understood the ordinary effect of dismissal to be reversion to the status quo ante. *Id.* at 45 (citing 11 U.S.C. § 349(b)(3); H.R. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977)).

The Drivers are correct that, as the Bankruptcy Court acknowledged, the Code does not expressly authorize structured dismissals. *See* App. 31 (Bankr. Op. 9). And as structured dismissals have occurred with increased frequency,[5] even commentators who seem to favor this trend have expressed uncertainty about whether the Code permits them.[6] As we understand them, however, structured dismissals are simply dismissals that are preceded by other orders of the bankruptcy court (*e.g.*, orders approving

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[5] *See* Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative After Asset Sales*, Am. Bankr. Inst. J., June 2010, at 1; *see, e.g.*, *In re Kainos Partners Holding Co.*, 2012 WL 6028927 (D. Del. Nov. 30, 2012); *World Health Alts.*, 344 B.R. at 293–95. *But cf. In re Biolitec, Inc.*, 2014 WL 7205395 (Bankr. D.N.J. Dec. 16, 2014) (rejecting a proposed structured dismissal as invalid under the Code).

[6] *See, e.g.*, Brent Weisenberg, *Expediting Chapter 11 Liquidating Debtor's Distribution to Creditors*, Am. Bankr. Inst. J., April 2012, at 36 ("[T]he time is ripe to make crystal clear that these procedures are in fact authorized by the Code."). *But cf.* Nan Roberts Eitel et al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, Am. Bankr. Inst. J., March 2011, at 20 (article by United States Trustee staff arguing that structured dismissals are improper under the Code).

settlements, granting releases, and so forth) that remain in effect after dismissal. And though § 349 of the Code contemplates that dismissal will typically reinstate the pre-petition state of affairs by revesting property in the debtor and vacating orders and judgments of the bankruptcy court, it also explicitly authorizes the bankruptcy court to alter the effect of dismissal "for cause"—in other words, the Code does not strictly require dismissal of a Chapter 11 case to be a hard reset. 11 U.S.C. § 349(b); H.R. Rep. No. 595 at 338 ("The court is permitted to order a different result for cause."); *see also Matter of Sadler*, 935 F.2d 918, 921 (7th Cir. 1991) ("'Cause' under § 349(b) means an acceptable reason.").

Quoting Justice Scalia's oft-repeated quip "Congress . . . does not, one might say, hide elephants in mouseholes," *Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001), the Drivers forcefully argue that Congress would have spoken more clearly if it had intended to leave open an end run around the procedures that govern plan confirmation and conversion to Chapter 7, Drivers' Br. 22. According to the Drivers, the position of the District Court, the Bankruptcy Court, and Appellees overestimates the breadth of bankruptcy courts' settlement-approval power under Rule 9019, "render[ing] plan confirmation superfluous" and paving the way for illegitimate *sub rosa* plans engineered by creditors with overwhelming bargaining power. *Id.*; *see also id.* at 24–25. Neither "dire circumstances" nor the bankruptcy courts' general power to carry out the provisions of the Code under 11 U.S.C. § 105(a), the Drivers say, authorizes a court to evade the Code's requirements. *Id.* at 32–35, 40–41.

But even if we accept all that as true, the Drivers have proved only that the Code forbids structured dismissals when they are used to circumvent the plan confirmation process or

conversion to Chapter 7. Here, the Drivers mount no real challenge to the Bankruptcy Court's findings that there was no prospect of a confirmable plan in this case and that conversion to Chapter 7 was a bridge to nowhere. So this appeal does not require us to decide whether structured dismissals are permissible when a confirmable plan is in the offing or conversion to Chapter 7 might be worthwhile. For present purposes, it suffices to say that absent a showing that a structured dismissal has been contrived to evade the procedural protections and safeguards of the plan confirmation or conversion processes, a bankruptcy court has discretion to order such a disposition.

B

Having determined that bankruptcy courts have the power, in appropriate circumstances, to approve structured dismissals, we now consider whether settlements in that context may ever skip a class of objecting creditors in favor of more junior creditors. *See In re Buffet Partners, L.P.*, 2014 WL 3735804, at *4 (Bankr. N.D. Tex. July 28, 2014) (approving a structured dismissal while "emphasiz[ing] that not one party with an economic stake in the case has objected to the dismissal in this manner"). The Drivers' primary argument in this regard is that even if structured dismissals are permissible, they cannot be approved if they distribute estate assets in derogation of the priority scheme of § 507 of the Code. They contend that § 507 applies to all distributions of estate property under Chapter 11, meaning the Bankruptcy Court was powerless to approve a settlement that skipped priority employee creditors in favor of tax and general unsecured creditors. Drivers' Br. 21, 35–36; *see* 11 U.S.C. § 103(a) ("[C]hapters 1, 3, and 5 of this title apply in a case under chapter 7, 11, 12, or 13[.]"); *Law v. Siegel*, 134 S. Ct.

1188, 1194 (2014) ("'[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of' the Bankruptcy Code." (citation omitted)).

The Drivers' argument is not without force. Although we are skeptical that § 103(a) requires settlements in Chapter 11 cases to strictly comply with the § 507 priorities,[7] there is some tacit support in the caselaw for the Drivers' position. For example, in *TMT Trailer Ferry*, the Supreme Court held that the "requirement[] . . . that plans of reorganization be both 'fair and equitable,' appl[ies] to compromises just as to other aspects of reorganizations." 390 U.S. at 424. The Court also noted that "a bankruptcy court is not to approve or confirm a plan of reorganization unless it is found to be 'fair and equitable.' This standard incorporates the absolute priority doctrine under which creditors and stockholders may participate only in accordance with their respective priorities[.]" *Id.* at 441; *see also* 11 U.S.C. § 1129(b)(2)(B)(ii) (codifying the absolute priority rule by requiring that a plan of reorganization pay senior creditors before junior creditors in order to be "fair and equitable" and confirmable). This latter statement comports with a line of cases describing "fair

[7] There is nothing in the Code indicating that Congress legislated with settlements in mind—in fact, the bankruptcy courts' power to approve settlements comes from a Federal Rule of Bankruptcy Procedure promulgated by the Supreme Court, not Congress. *See* Rules Enabling Act, 28 U.S.C. § 2075. If § 103(a) meant that all distributions in Chapter 11 cases must comply with the priorities of § 507, there would have been no need for Congress to codify the absolute priority rule specifically in the plan confirmation context. *See* 11 U.S.C. § 1129(b)(2)(B)(ii).

and equitable" as "'words of art' which mean that senior interests are entitled to full priority over junior ones[.]" *SEC v. Am. Trailer Rentals Co.*, 379 U.S. 594, 611 (1965); *accord Otis & Co. v. SEC*, 323 U.S. 624, 634 (1945); *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 115–16 (1939).

Although these cases provide some support to the Drivers, they are not dispositive because each of them spoke in the context of plans of reorganization, not settlements. *See, e.g.*, *TMT Trailer Ferry*, 424 U.S. at 441; *Am. Trailer Rentals*, 379 U.S. at 611; *see also In re Armstrong World Indus., Inc.*, 432 F.3d 507 (3d Cir. 2005) (applying the absolute priority rule to deny confirmation of a proposed plan). When Congress codified the absolute priority rule discussed in the line of Supreme Court decisions cited above, it did so in the specific context of plan confirmation, *see* § 1129(b)(2)(B)(ii), and neither Congress nor the Supreme Court has ever said that the rule applies to settlements in bankruptcy. Indeed, the Drivers themselves admit that the absolute priority rule "plainly does not apply here," even as they insist that the legal principle embodied by the rule dictates a result in their favor. Drivers' Br. 37.

Two of our sister courts have grappled with whether the priority scheme of § 507 must be followed when settlement proceeds are distributed in Chapter 11 cases. In *Matter of AWECO, Inc.*, the Court of Appeals for the Fifth Circuit rejected a settlement of a lawsuit against a Chapter 11 debtor that would have transferred $5.3 million in estate assets to an unsecured creditor despite the existence of outstanding senior claims. 725 F.2d 293, 295–96 (1984). The Court held that the "fair and equitable" standard applies to settlements, and "fair and equitable" means compliant with the priority system. *Id.* at 298.

Criticizing the Fifth Circuit's rule in *AWECO*, the Second Circuit adopted a more flexible approach in *In re Iridium Operating LLC*, 478 F.3d 452 (2007). There, the unsecured creditors' committee sought to settle a suit it had brought on the estate's behalf against a group of secured lenders; the proposed settlement split the estate's cash between the lenders and a litigation trust set up to fund a different debtor action against Motorola, a priority administrative creditor. *Id.* at 456, 459–60. Motorola objected to the settlement on the ground that the distribution violated the Code's priority system by skipping Motorola and distributing funds to lower-priority creditors. *Id.* at 456. Rejecting the approach taken by the Fifth Circuit in *AWECO* as "too rigid," the Second Circuit held that the absolute priority rule "is not necessarily implicated" when "a settlement is presented for court approval apart from a reorganization plan[.]" *Id.* at 463–64. The Court held that "whether a particular settlement's distribution scheme complies with the Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable' under Rule 9019," but a noncompliant settlement could be approved when "the remaining factors weigh heavily in favor of approving a settlement[.]" *Id.* at 464.

Applying its holding to the facts of the case, the Second Circuit noted that the settlement at issue deviated from the Code priorities in two respects: first, by skipping Motorola in distributing estate assets to the litigation fund created to finance the unsecured creditors committee's suit against Motorola; and second, by skipping Motorola again in providing that any money remaining in the fund after the litigation concluded would go straight to the unsecured creditors. 478 F.3d at 459, 465–66. The Court indicated that

the first deviation was acceptable even though it skipped Motorola:

> It is clear from the record why the Settlement distributes money from the Estate to the [litigation vehicle]. The alternative to settling with the Lenders—pursuing the challenge to the Lenders' liens—presented too much risk for the Estate, including the administrative creditors. If the Estate lost against the Lenders (after years of litigation and paying legal fees), the Estate would be devastated, all its cash and remaining assets liquidated, and the Lenders would still possess a lien over the Motorola Estate Action. Similarly, administrative creditors would not be paid if the Estate was unsuccessful against the Lenders. Further, as noted at the Settlement hearing, having a well-funded litigation trust was preferable to attempting to procure contingent fee-based representation.

Id. at 465–66. But because the record did not adequately explain the second deviation, the Court remanded the case to allow the bankruptcy court to consider that issue. *Id.* at 466 ("[N]o reason has been offered to explain why any balance left in the litigation trust could not or should not be distributed pursuant to the rule of priorities.").

We agree with the Second Circuit's approach in *Iridium*—which, we note, the Drivers and the United States Trustee cite throughout their briefs and never quarrel with. *See* Drivers' Br. 27, 36; Reply Br. 11–13; Trustee Br. 21. As in other areas of the law, settlements are favored in bankruptcy. *In re Nutraquest*, 434 F.3d 639, 644 (3d Cir. 2006). "Indeed, it is an unusual case in which there is not

some litigation that is settled between the representative of the estate and an adverse party." *Martin*, 91 F.3d at 393. Given the "dynamic status of some pre-plan bankruptcy settlements," *Iridium*, 478 F.3d at 464, it would make sense for the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure to leave bankruptcy courts more flexibility in approving settlements than in confirming plans of reorganization. For instance, if a settlement is proposed during the early stages of a Chapter 11 bankruptcy, the "nature and extent of the [e]state and the claims against it" may be unresolved. *Id.* at 464. The inquiry outlined in *Iridium* better accounts for these concerns, we think, than does the per se rule of *AWECO*.

At the same time, we agree with the Second Circuit's statement that compliance with the Code priorities will usually be dispositive of whether a proposed settlement is fair and equitable. *Id.* at 455. Settlements that skip objecting creditors in distributing estate assets raise justifiable concerns about collusion among debtors, creditors, and their attorneys and other professionals. *See id.* at 464. Although Appellees have persuaded us to hold that the Code and the Rules do not extend the absolute priority rule to settlements in bankruptcy, we think that the policy underlying that rule—ensuring the evenhanded and predictable treatment of creditors—applies in the settlement context. As the Drivers note, nothing in the Code or the Rules obliges a creditor to cut a deal in order to receive a distribution of estate assets to which he is entitled. Drivers' Br. 42–43. If the "fair and equitable" standard is to have any teeth, it must mean that bankruptcy courts cannot approve settlements and structured dismissals devised by certain creditors in order to increase their shares of the estate at the expense of other creditors. We therefore hold that bankruptcy courts may approve settlements that deviate from

the priority scheme of § 507 of the Bankruptcy Code only if they have "specific and credible grounds to justify [the] deviation." *Iridium*, 478 F.3d at 466.

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We admit that it is a close call, but in view of the foregoing, we conclude that the Bankruptcy Court had sufficient reason to approve the settlement and structured dismissal of Jevic's Chapter 11 case. This disposition, unsatisfying as it was, remained the least bad alternative since there was "no prospect" of a plan being confirmed and conversion to Chapter 7 would have resulted in the secured creditors taking all that remained of the estate in "short order." App. 32 (Bankr. Op. 10).

Our dissenting colleague's contrary view rests on the counterfactual premise that the parties could have reached an agreeable settlement that conformed to the Code priorities. He would have us make a finding of fact to that effect and order the Bankruptcy Court to redesign the settlement to comply with § 507. We decline to do so because, even if it were appropriate for us to review findings of fact de novo and equitably reform settlements on appeal, there is no evidence calling into question the Bankruptcy Court's conclusion that there was "no realistic prospect" of a meaningful distribution to Jevic's unsecured creditors apart from the settlement under review. App. 32 (Bankr. Op. 10). If courts required settlements to be perfect, they would seldom be approved; though it's regrettable that the Drivers were left out of this one, the question—as Judge Scirica recognizes—is whether the settlement serves the interests of the estate, not one particular group of creditors. There is no support in the record for the proposition that a viable alternative existed that would have better served the estate and the creditors as a whole.

The distribution of Jevic's remaining $1.7 million to all creditors but the Drivers was permissible for essentially the same reasons that the initial distribution of estate assets to the litigation fund was allowed by the Second Circuit in *Iridium*.[8] As in that case, here the Bankruptcy Court had to choose between approving a settlement that deviated from the priority scheme of § 507 or rejecting it so a lawsuit could proceed to deplete the estate. Although we are troubled by the fact that the exclusion of the Drivers certainly lends an element of unfairness to the first option, the second option would have served the interests of neither the creditors nor the estate. The Bankruptcy Court, in Solomonic fashion, reluctantly approved the only course that resulted in some payment to creditors other than CIT and Sun.

* * *

Counsel for the United States Trustee told the Bankruptcy Court that it is immaterial whether there is a viable alternative to a structured dismissal that does not

[8] Judge Scirica reads *Iridium* as involving a settlement that deviated from the § 507 priority scheme in just one respect, and a minor one at that. As we have explained, however, the *Iridium* settlement involved two deviations: (1) the initial distribution of estate funds to the litigation fund created to sue Motorola; and (2) the contingent provision that money left in the fund after the litigation concluded would go directly to the unsecured creditors. *See supra* Section III-B. The Second Circuit held that, while the second deviation needed to be explained on remand, the first was acceptable despite the fact that it impaired Motorola because it clearly served the interests of the estate. *See Iridium*, 478 F.3d at 465–66.

comply with the Bankruptcy Code's priority scheme. "[W]e have to accept the fact that we are sometimes going to get a really ugly result, an economically ugly result, but it's an economically ugly result that is dictated by the provisions of the code," he said. App. 1327. We doubt that our national bankruptcy policy is quite so nihilistic and distrustful of bankruptcy judges. Rather, we believe the Code permits a structured dismissal, even one that deviates from the § 507 priorities, when a bankruptcy judge makes sound findings of fact that the traditional routes out of Chapter 11 are unavailable and the settlement is the best feasible way of serving the interests of the estate and its creditors. Although this result is likely to be justified only rarely, in this case the Bankruptcy Court provided sufficient reasons to support its approval of the settlement under Rule 9019. For that reason, we will affirm the order of the District Court.

SCIRICA, *Circuit Judge*

I concur in parts of the Court's analysis in this difficult case, but I respectfully dissent from the decision to affirm. Rejection of the settlement was called for under the Bankruptcy Code and, by approving the settlement, the bankruptcy court's order undermined the Code's essential priority scheme. Accordingly, I would vacate the bankruptcy court's order and remand for further proceedings, described below.

At the outset, I should state that this is not a case where equitable mootness applies. We recently made clear in *In re Semcrude, L.P.*, 728 F.3d 314 (3d Cir. 2013), that this doctrine applies only where there is a confirmed plan of reorganization. I would also adopt the Second Circuit's standard from *In re Iridium Operating LLC*, 478 F.3d 452 (2d Cir. 2007), and hold that settlements presented outside of plan confirmations must, absent extraordinary circumstances, comply with the Code's priority scheme.

Where I depart from the majority opinion, however, is in holding this appeal presents an extraordinary case where departure from the general rule is warranted. The bankruptcy court believed that because no confirmable Chapter 11 plan was possible, and because the only alternative to the settlement was a Chapter 7 liquidation in which the WARN Plaintiffs would have received no recovery, compliance with the Code's priority scheme was not required. For two reasons, however, I respectfully dissent.

First, it is not clear to me that the only alternative to the settlement was a Chapter 7 liquidation. An alternative settlement might have been reached in Chapter 11, and might have included the WARN Plaintiffs. The reason that such a settlement was not reached was that one of the defendants being released (Sun) did not want to fund the WARN Plaintiffs in their ongoing litigation against it. As Sun's counsel explained at the settlement hearing, "if the money goes to the WARN plaintiffs, then you're funding someone who is suing you who otherwise doesn't have funds and is doing it on a contingent fee basis." Sun therefore insisted that, as a condition to participating in the fraudulent conveyance action settlement, the WARN Plaintiffs would have to drop their WARN claims. Accordingly, to the extent that the only alternative to the settlement was a Chapter 7 liquidation, that reality was, at least in part, a product of appellees' own making.

More fundamentally, I find the settlement at odds with the goals of the Bankruptcy Code. One of the Code's core goals is to maximize the value of the bankruptcy estate, *see Toibb v. Radloff*, 501 U.S. 157, 163 (1991), and it is the duty of a bankruptcy trustee or debtor-in-possession to work toward that goal, including by prosecuting estate causes of action,[1] *see Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352 (1985); *Official Comm. of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548, 573 (3d Cir. 2003). The reason creditors'

[1] Of course, it was the creditors' committee, rather than a bankruptcy trustee or debtor-in-possession, who was responsible for prosecuting the fraudulent conveyance action here.

committees may bring fraudulent conveyance actions on behalf of the estate is that such committees are likely to maximize estate value; "[t]he possibility of a derivative suit by a creditors' committee provides a critical safeguard against lax pursuit of avoidance actions [by a debtor-in-possession]." *Cybergenics*, 330 F.3d at 573. The settlement of estate causes of action can, and often does, play a crucial role in maximizing estate value, as settlements may save the estate the time, expense, and uncertainties associated with litigation. *See Protective Comm. for Ind. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968) ("In administering reorganization proceedings in an economical and practical manner it will often be wise to arrange the settlement of claims as to which there are substantial and reasonable doubts."); *In re A&C Props.*, 784 F.2d 1377, 1380-81 (9th Cir. 1986) ("The purpose of a compromise agreement is to allow the trustee and the creditors to avoid the expenses and burdens associated with litigating sharply contested and dubious claims."). Thus, to the extent that a settlement's departure from the Code's priority scheme was necessary to maximize the estate's overall value, I would not object.

But here, it is difficult to see how the settlement is directed at estate-value maximization. Rather, the settlement deviates from the Code's priority scheme so as to maximize the recovery that certain creditors receive, some of whom (the unsecured creditors) would not have been entitled to recover anything in advance of the WARN Plaintiffs had the estate property been liquidated and distributed in Chapter 7 proceedings or under a Chapter 11 "cramdown." There is, of course, a substantial difference between the estate itself and specific estate constituents. The estate is a distinct legal

entity, and, in general, its assets may not be distributed to creditors except in accordance with the strictures of the Bankruptcy Code.[2]

In this sense, then, the settlement and structured dismissal raise the same concern as transactions invalidated under the *sub rosa* plan doctrine. In *In re Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983), the Court of Appeals for the Fifth Circuit rejected an asset sale that "had the practical effect of dictating some of the terms of any future reorganization plan." *Id.* at 940. The sale was impermissible because the transaction "short circuit[ed] the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with a sale of assets." *Id.* "When a proposed transaction specifies terms for adopting a reorganization plan, 'the parties and the district court must scale the hurdles erected in Chapter 11.'"

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[2] This point is reinforced with an analogy to trust law. Where there are two or more beneficiaries of a trust, the trustee is under a duty to deal with them impartially, and cannot take an action that rewards certain beneficiaries while harming others. Restatement (Second) of Trusts § 183 (1959); *see also Varity Corp. v. Howe*, 516 U.S. 489, 514 (1996) ("The common law of trusts recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interests of all beneficiaries."). Yet that is what the Committee did here. This duty persists even where the trustee is a beneficiary of the trust himself, like the creditors' committee was here. *See* Restatement (Third) of Trusts § 32 (2003) ("A natural person, including a settlor or beneficiary, has capacity . . . to administer trust property and act as trustee . . . .")

In re Cont'l Air Lines, Inc., 780 F.2d 1223, 1226 (5th Cir. 1986) (quoting *Braniff*, 700 F.2d at 940). Although the combination of the settlement and structured dismissal here does not, strictly speaking, constitute a *sub rosa* plan — the hallmark of such a plan is that it dictates the terms of a reorganization plan, and the settlement here does not do so — the broader concerns underlying the *sub rosa* doctrine are at play. The settlement reallocated assets of the estate in a way that would not have been possible without the authority conferred upon the creditors' committee by Chapter 11 and effectively terminated the Chapter 11 case, but it failed to observe Chapter 11's "safeguards of disclosure, voting, acceptance, and confirmation." *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1982); *see also In re Biolitec Inc.*, No. 13-11157, 2014 WL 7205395, at *8 (Bankr. D.N.J. Dec. 17, 2014) (rejecting settlement and structured dismissal that assigned rights and interests but did not allow parties to vote on settlement's provisions in part because it "resemble[d] an impermissible *sub rosa* plan"). This settlement then appears to constitute an impermissible end-run around the carefully designed routes by which a debtor may emerge from Chapter 11 proceedings.

Critical to this analysis is the fact that the money paid by the secured creditors in the settlement was property of the estate. A cause of action held by the debtor is property of the estate, *see Bd. of Trs. of Teamsters Local 863 v. Foodtown, Inc.*, 296 F.3d 164, 169 (3d Cir. 2002), and "proceeds . . . of or from property of the estate" are considered estate property as well, 11 U.S.C. § 541(a)(6). Here, the administrative and unsecured creditors received the $3.7 million as consideration for the releases from the fraudulent conveyance action, so this payment qualifies as "proceeds" from the estate's cause of

action.[3] *See* Black's Law Dictionary 1325 (9th ed. 2009) (defining proceeds as "[s]omething received upon selling, exchanging, collecting, or otherwise disposing of collateral"); *see also Strauss v. Morn*, Nos. 97-16481 & 97-16483, 1998 WL 546957, at *3 (9th Cir. 1998) ("§ 541(a)(6) mandates the broad interpretation of the term 'proceeds' to encompass all proceeds of property of the estate"); *In re Rossmiller*, No. 95-1249, 1996 WL 175369, at *2 (10th Cir. 1996) (similar). This case is thus distinguishable from the so-called "gifting" cases such as *In re World Health Alternatives*, 344 B.R. 291 (Bankr. D. Del. 2006), and *In re SPM Manufacturing Corp.*, 984 F.2d 1305 (1st Cir. 1993). In fact, those courts explicitly distinguished estate from non-estate property, and approved the class-skipping arrangements only because the proceeds being distributed were *not* estate property. *See World Health*, 344 B.R. at 299-300; *SPM*, 984 F.3d at 1313. The arrangement here is closer to a § 363 asset sale where the proceeds from the debtor's assets are distributed directly to certain creditors, rather than the bankruptcy estate. *Cf. In re Chrysler LLC*, 576 F.3d 108, 118 (2d Cir. 2009) (noting, in upholding a § 363 sale, that the bankruptcy court

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[3] On June 30, 2006, Sun acquired Jevic in a leveraged buyout, which included an $85 million revolving credit facility from a bank group led by CIT. The fraudulent conveyance action complaint sets forth that Jevic and Sun allegedly knew that Jevic would default on the CIT financing agreement by September 11 of that year. The fraudulent conveyance action sought over $100 million in damages, and the unsecured creditors' committee alleged that "[w]ith CIT's active assistance . . . Sun orchestrated a[n] . . . LBO whereby Debtors' assets were leveraged to enable a Sun affiliate to pay $77.4 million . . . with no money down."

demonstrated "proper solicitude for the priority between creditors and deemed it essential that the [s]ale in no way upset that priority"), *vacated as moot*, 592 F.3d 370. It is doubtful that such an arrangement would be permissible.

The majority likens the deviation in this case to the first deviation in *Iridium*, in which the settlement would initially distribute funds to the litigation trust instead of the Motorola administrative creditors. For two reasons, however, I find this analogy unavailing. First, it is not clear to me that the Second Circuit saw the settlement's initial distribution of funds to the litigation trust as a deviation from the Code's priority scheme at all. As the Second Circuit explained, if the litigation was successful, the majority of the proceeds from that litigation would actually flow back to the estate, then to be distributed in accordance with the Code's priority scheme. 459 F.3d at 462.[4] Second, the critical (and, in my view, determinative) characteristic of the settlement in this case is that it skips over an entire class of creditors. That is precisely what the second "deviation" in *Iridium* did, and the Second Circuit remanded to the bankruptcy court for further consideration of that aspect of the settlement.

In fact, the second "deviation" in *Iridium* deviated from the priority scheme in a more minor way than the settlement at issue here. In *Iridium*, the settlement would have deviated from the priority scheme only in the event that Motorola, an administrative creditor and a defendant in various litigation matters brought by the creditors' committee, had prevailed in the litigation or if its administrative claims

[4] Here, by contrast, none of the settlement proceeds flowed to the estate.

had exceeded its liability in the litigation. *Iridium*, 478 F.3d at 465. The Second Circuit thus characterized this aspect of the settlement as a mere "possible deviation" in "one regard," but nevertheless remanded for the bankruptcy court to assess the "possible" deviation's justification. *Id.* at 466. Here, of course, it is clear that the settlement deviates from the priority scheme, as it provides no compensation for an entire class of priority creditors, while providing $1.7 million to the general unsecured creditors.

Finally, I do not question the factual findings made by the bankruptcy court. That court found that there was "no realistic prospect" of a meaningful distribution to Jevic's unsecured creditors apart from the settlement under review. But whether there was a realistic prospect of distribution to the unsecured creditors in the absence of this settlement is not relevant to my concerns. What matters is whether the settlement's deviation from the priority scheme was necessary to maximize the value of the *estate*. There is a difference between the estate and certain creditors of the estate, and there has been no suggestion that the deviation maximized the value of the estate itself.

The able bankruptcy court here was faced with an unpalatable set of alternatives. But I do not believe the situation it faced was entirely *sui generis*. It is not unusual for a debtor to enter bankruptcy with liens on all of its assets, nor is it unusual for a debtor to enter Chapter 11 proceedings — the flexibility of which enabled appellees to craft this settlement in the first place — with the goal of liquidating,

rather than rehabilitating, the debtor.[5] It is also not difficult to imagine another secured creditor who wants to avoid providing funds to priority unsecured creditors, particularly where the secured creditor is also the debtor's ultimate parent and may have obligations to the debtor's employees. Accordingly, approval of the bankruptcy court's ruling in this case would appear to undermine the general prohibition on settlements that deviate from the Code's priority scheme.

I recognize that if the settlement were unwound, this case would likely be converted to a Chapter 7 liquidation in

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[5] *See* Ralph Brubaker, *The Post*-RadLAX *Ghosts of* Pacific Lumber *and* Philly News *(Part II): Limiting Credit Bidding*, Bankr. L. Letter, July 2014, at 4 (describing the "ascendancy of secured credit in Chapter 11 debtors' capital structures, such that it is now common that a dominant secured lender has blanket liens on substantially all of the debtor's assets securing debts vastly exceeding the value of the debtor's business and assets"); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control & Conflict in Chapter 11*, 1 J.L. Analysis 511, 519 (2009) (finding that secured claims exceeded the value of the company in twenty-two percent of the bankruptcies surveyed); Stephen J. Lubben, *Business Liquidation*, 81 Am. Bankr. L.J. 65 (2007) (noting that although "chapter 7 is the prevailing method of business liquidation, . . . a sizable number of firms first attempt either a reorganization or liquidation under chapter 11"); 11 U.S.C. § 1123(b)(4) (providing that a chapter 11 plan may "provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests").

which the secured creditors would be the only creditors to recover. Accordingly, I would not unwind the settlement entirely. Instead, I would permit the secured creditors to retain the releases for which they bargained and would not disturb any of the proceeds received by the administrative creditors either. But I would also require the bankruptcy court to determine the WARN Plaintiffs' damages under the New Jersey WARN Act, as well as the proportion of those damages that qualifies for the wage priority.[6] I would then have the court order any proceeds that were distributed to creditors with a priority lower than that of the WARN Plaintiffs disgorged, and apply those proceeds to the WARN Plaintiffs' wage priority claim. To the extent that funds are left over, I would have the court redistribute them to the remaining creditors in accordance with the Code's priority scheme.

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[6] At this point, the WARN litigation has largely concluded, with the WARN Plaintiffs having established liability on their New Jersey WARN claims against Jevic but having lost on all other claims. On May 10, 2013, the bankruptcy court dismissed the WARN Plaintiffs' claims against Sun (but not Jevic) on the grounds that Sun was not a "single employer" for purposes of the WARN Acts. The district court affirmed that decision on September 29, 2014. *In re Jevic Holding Corp.*, No. 13-1127-SLR, 2014 WL 4949474 (D. Del. Sept. 29, 2014). In a separate opinion on May 10, 2013, the bankruptcy court dismissed the federal WARN Act claims against Jevic, but granted summary judgment in favor of the WARN Plaintiffs against Jevic on their New Jersey WARN Act claims. No appeal was taken of that ruling; in fact, Jevic did not contest liability on the New Jersey WARN Act claims.

Additional NBC Committee to Rethink Chapter 11 Reports:

Liquidation Asymmetries

MEMORANDUM

TO: National Bankruptcy Conference

FROM: NBC Committee to Rethink Chapter 11

DATE: December 8, 2014

RE: Liquidation Asymmetries

The Committee has recognized that asymmetries exist between a liquidation under chapter 7 of the Bankruptcy Code and one under chapter 11 of the Bankruptcy Code and has questioned whether such differences are warranted. Moreover, the Committee has noted the limited options for resolving a liquidating chapter 11 case. Specifically, after a sale of substantially all of a chapter 11 debtor's assets, if the estate remains administratively solvent, the only prescribed method for concluding the chapter 11 case is through a liquidating plan. This is so even if the creditors (the residual value holders) would prefer to forego the expense and delay attendant to the plan process. Conversely, if the estate post-sale is or is likely to be administratively insolvent, there is usually a push for conversion of the case to chapter 7 even if the creditors do not wish to cede their voice in the proceedings to a trustee (whom they by and large do not choose) or fund the trustee's learning curve. Accordingly, this Memorandum explores the differences that currently exist between chapter 7 and a liquidating chapter 11 case in light of the foregoing practical considerations, presents the recommendations of the Committee with respect to the asymmetries that exist between a liquidation under chapter 7 of the Bankruptcy Code and one under chapter 11 of the Bankruptcy Code and suggests an alternative way of proceeding in a chapter 11 liquidation scenario while taking into account certain concerns raised by various Conferees at the November 2013 meeting.

Introduction

It is undeniable that several asymmetries exist between the provisions governing a liquidation conducted under chapter 7 and one conducted under chapter 11 of the Bankruptcy Code. A legitimate debate may be had regarding whether or not such differences warrant modification of the Bankruptcy Code as it now exists.

On the one hand, one may take the position that the existing statutory regime works well in most cases and that it sufficiently meets the desired policy objectives. Statutory provisions, such as the "best interests" plan confirmation requirement and the ability to convert a case to chapter 7, serve to protect creditors and other interest holders from the harm associated with differences between the two chapters. Further, in the context of a liquidating chapter 11 case, the courts have manifested a willingness to apply chapter 11 rules in a manner that is informed by chapter 7 practice. Therefore, given the existing statutory and case law, the system works well, and statutory modification offers little in the way of advancement.

On the other hand, one may alternatively take the position that the differences between the two chapters are substantial and that, even if they are not so substantial, there is no sound policy justification to tolerate any asymmetries. Under this view, the "best interests" test and other statutory provisions do not fully or sufficiently mitigate the differences between a liquidation under chapter 7 and one under chapter 11. Moreover, judge-made doctrines that elide the differences between the two chapters are, at best, an incomplete patchwork approach to solving the problem and, at worst, in tension with the controlling statutory law. In short, given the undeniable existence of asymmetries between a liquidation under these two chapters, statutory amendments are both necessary and desirable.

To the extent one subscribes to the first viewpoint, then no statutory solution is necessary and, indeed, any amendments to the Bankruptcy Code would simply result in uncertainty, litigation and increased costs. However, to the extent one subscribes to the second viewpoint, then amendments to the Bankruptcy Code would be warranted. Such amendments could take various forms. For example, one way to address asymmetries between the two chapters is simply to eliminate one chapter or the other as an option for a liquidating corporate debtor, perhaps taking into account the magnitude of the debtor's operations, assets or liabilities. Another solution is to amend the Bankruptcy Code to make various provisions operative or inoperative in the context of a corporate debtor's liquidation, regardless of whether the debtor is proceeding under chapter 7 or 11 of the Bankruptcy Code. Yet another solution is to extend, in appropriate cases (again, perhaps taking into account the magnitude of the debtor's operations, assets and/or liabilities), the concept of the debtor in possession to the context of a chapter 7 liquidation. Numerous other intermediate possibilities similarly exist. Each solution has potential benefits and issues associated with it.

Chapter 11 liquidation situations often present themselves (i) after the consummation of sales of substantially all of a debtor's assets or (ii) in instances where operations have been shut down and assets must be liquidated – sometimes for a debtor with significant and far-flung operations (*e.g.*, LTV II, Hostess Brands, Caldor, and FLYi). In either case, the specter of administrative insolvency is often present, but, particularly in the second scenario, the strictures of chapter 7 are

insufficient to address the complications of shutting down and winding up a large corporate enterprise or partnership. The Committee believes that it is useful for a debtor to be able to conduct an orderly liquidation using the tools and flexibility found in a chapter 11 case, particularly large and complicated chapter 11 cases where (i) the possibility of significant and/or multiple causes of action exist and (ii) creditors are desirous of negotiating the allocation and distribution of proceeds, even in (or, perhaps, particularly in) an administratively insolvent case. Care, however, must be taken not to "entrench" prior management or their advisors or parallel sets of professionals engaged in overlapping tasks (*e.g.*, debtor and committee professionals) when pursuing a liquidation path that is designed to maximize value.

Accordingly, in light of the foregoing, the Committee believes that the existing asymmetries between a liquidation under chapter 7 and one under chapter 11 warrant amending the Bankruptcy Code. The Committee further submits that the optimal solution builds on existing law and practice but ameliorates the asymmetries between a liquidation of a corporation or partnership under chapter 7 and one under chapter 11 (the "***Liquidation Option***").

Some of the salutary effects of liquidating a corporate debtor or partnership without conversion include: (i) fostering an agreement between the debtor and its creditors regarding how the resolution of the case should occur, (ii) preserving the ability for creditors to negotiate a consensual solution to the distribution of proceeds in a case while having a clear fall-back position in the absolute priority rule, (iii) presumably, preserving additional value attributable to the debtor's assets by avoiding the "fire sale" stigma of a chapter 7 appellation and (iv) avoiding potential inefficiencies and the inevitable learning curve involved in the mandatory appointment of a chapter 7 trustee in all cases of conversion, even if that might not be the optimal path to maximize value for creditors.

Proceeding Under the Liquidation Option

As noted above, chapter 11 already contemplates and accommodates liquidating cases. Chapter 11 liquidating plans can follow the absolute priority rule or can implement settlements and agreements with respect to claims treatment and distributions among the debtor and its creditors. The Liquidation Option proposed herein is intended to expand on the flexibility that already exists in the law and practice, and the attendant goal of promoting agreements among the debtor and creditors in a case, while both filling in gaps in the law that do not clearly address certain liquidation scenarios and harmonizing provisions of chapter 7 and chapter 11 in business liquidations.

The Liquidation Option would become available to a debtor upon: (a) in the context of a sale of the debtor's assets, a determination that the estate is or is likely to be administratively insolvent (the "***Administrative Insolvency Requirement***"); or (b)(i) the complete cessation of the debtor's operations *and* (ii) the consummation of a sale or sales of all or substantially all of the debtor's assets and the windup of the debtor (the "***Shutdown/Sale Requirement***"). The Committee's view is that the two Requirement triggers could be determined either on a debtor-by-debtor basis or on an aggregate basis in jointly-administered proceedings if the debtors have not previously been substantively consolidated. Consistent with this view toward flexibility, the Committee

believes that a single debtor in a jointly-administered case should be able to avail itself of the Liquidation Option if it alone sells all or substantially all of its assets and if the debtors have not previously been substantively consolidated.[1]

Once either the Administrative Insolvency Requirement or the Shutdown/Sale Requirement is satisfied, a debtor[2] would automatically proceed under the Liquidation Option (subject to lender funding agreement, discussed in the paragraph below). Once one of the Requirements has occurred, the debtor, after consultation with its primary creditor constituencies, must make an election (the ***"Election"***) to proceed under a liquidating plan or under the dismissal route and must file a ***Notice of Election*** with the Bankruptcy Court. The Notice of Election must state whether the debtor intends to conduct the liquidation with or without a liquidating plan and, if the debtor intends to proceed without a liquidating plan, the Notice of Election must set forth the manner in which the debtor proposes to liquidate its assets, make distributions and conclude its case. The matters to be specified in the Notice of Election include, without limitation, who will manage the liquidation; which professionals will be used by the estate representative; whether any official committee will remain in existence and, if so, the scope of its functions and those of its professionals and how redundancies between the work of its professionals and those of the estate representative will be avoided. The Notice of Election would be given to all parties-in-interest,[3] who would then have a period of time to challenge the procedures set forth therein.[4]

If an objection to the procedures proposed in the Notice of Election is timely filed, the Bankruptcy Court will hold a hearing to determine the matter utilizing a "best interests of the estate and creditors" standard. Objecting parties may set forth in their objections alternative means of proceeding, which the Bankruptcy Court may consider. The Bankruptcy Court need not give deference to a debtor's choices in the Notice of Election and may give equal consideration to the options proposed in any objection (including any options with respect to the continued role of management, the retention or replacement of existing professionals for the debtor and the retention or disbandment of the Creditors' Committee and its professionals and any limitations on their role and functions) and to conversion of the case. At the conclusion of the hearing, the Court must have sufficient evidence for it to be able to make a finding that proceeding in the manner ordered is better for the estate and creditors than conversion of the case to one under chapter 7. If no objection is timely filed to the debtor's Notice of Election, however, the Committee believes that the manner in which the debtor proposes to proceed

[1] The Committee adopts this view solely for purposes of the Liquidation Option; the Committee expresses no view as to the appropriateness of consolidating or not consolidating debtors for other purposes in a bankruptcy case – *e.g.*, for determining issues of adequate protection.

[2] For ease of reference, the debtor in possession or trustee will simply be referred to as "the debtor" throughout.

[3] The Committee suggests that the bankruptcy courts should retain flexibility to prescribe the notice required for due process under the facts and circumstances of the particular case. This may include both traditional and non-traditional (perhaps more cost-effective) ways of giving notice, such as through EDGAR and/or websites established by the debtor or committee(s) in the case The Committee suggests that the Rules Committee give consideration to this issue as well..

[4] The Committee suggests a 21-day notice period.

should be self-effectuating. The order approving the method of proceeding shall be referred to herein as the "***Liquidation Process Order***"

Generally speaking, under the Liquidation Option, the estate would: (i) liquidate the debtor's remaining assets and (ii) distribute the net proceeds of such assets according either to creditor agreement or, absent agreement, the absolute priority rule, either (y) pursuant to a liquidating plan if the debtor is administratively solvent and chooses to proceed with the plan requirements or (z) pursuant to the process approved in the Liquidation Process Order. If the debtor is or is likely to be administratively insolvent or if the debtor is administratively solvent but chooses to proceed without a plan of liquidation, the case would be dismissed under section 1112 of the Bankruptcy Code without confirmation of a chapter 11 plan after all assets are liquidated and the final distribution is made pursuant to the Liquidation Process Order. Provision for funding the liquidation and windup process must be made in advance with the debtor's secured lender(s), if any, and such funding provisions must be set forth in the Notice of Election filed by the debtor. Failure of a secured lender to agree to such funding would constitute cause to convert the case to one under chapter 7 or to dismiss the case.

Balancing the Disparities Between Chapter 7 and Chapter 11 Under the Liquidation Option

1. Section 723

There are several provisions in chapter 7 that have no analogue to provisions in chapter 11. Section 723 of the Bankruptcy Code, for example, grants a trustee of a partnership debtor a contribution claim against general partners and establishes certain rules in connection with the assertion of such rights. Several cases have expressly refused to apply section 723 of the Bankruptcy Code to a chapter 11 debtor.[5] The lack of an analogous provision in chapter 11 may be ameliorated by the application of the "best interests" test.[6] In addition, a debtor in possession might achieve a result similar to the result under section 723 to the extent non-bankruptcy law endows a partnership with a contribution claim against its partners.[7] Accordingly, the degree of

[5] *See, e.g., In re The Monetary Group*, 55 B.R. 297, 298-99 (Bankr. M.D. Fla. 1985) ("Section 723 is a part of subchapter II of Chapter 7, therefore, according to § 103(b), § 723 is available to a trustee only in a case under Chapter 7. … The fact that the debtors involved are in a liquidating Chapter 11 case does not affect the express provisions of § 103(b)."); *see also In re Kaveney*, 60 B.R. 34, 36 (B.A.P. 9th Cir. B.A.P. 1985) ("We construe § 723(a), when read in the context of the whole Bankruptcy Code, as applying only to Chapter 7 partnership cases.").

[6] *See, e.g., In re The Monetary Group*, 55 B.R. 297, 299 (Bankr. M.D. Fla. 1985) ("Section 723 would be available to a trustee or debtor-in-possession in a Chapter 7 case. Therefore, if the general partners were solvent and could satisfy any deficiency in the payment of debts of the partnership then the Chapter 11 plan could not be confirmed [under the best interests test] *unless* the plan provided for a 100% pay-out to all creditors."). *But see In re Duval Manor Assocs.*, 191 B.R. 622, 636 (Bankr. E.D. Pa. 1996) (refusing to consider section 723(a) claim for purposes of best interests analysis where creditors retained their right to pursue the debtor's general partners under state law).

[7] *See Madison Assocs. v. Baldante (In re Madison Assocs.)*, 183 B.R. 206, 215 n.11 (C.D. Cal. 1995) (noting "[w]hile there is no equivalent provision [to section 723] applicable to Chapter 11 cases, the Debtor is

difference between chapter 11 liquidating partnerships and chapter 7 liquidating partnerships may turn on applicable nonbankruptcy law.

Because of the uncertainty of outcome evidenced by conflicting case law and because there does not appear to be any principled reason to modify this rule under the Liquidation Option, the Committee recommends that section 723 should apply under the Liquidation Option.

2. Section 724

Section 724 similarly does not apply in a chapter 11 case.[8] That section provides for the avoidance of certain liens and subordinates certain tax liens to other liens and administrative expenses. No analogue to this provision exists in chapter 11.

The Committee recommends that section 724 should apply under the Liquidation Option.

3. Section 726

Section 726 also does not apply in a chapter 11 case. Subsection (a) of section 726 provides a distribution scheme for property of the estate in a chapter 7 case. Among other things, the subsection provides (i) untimely claims either second or third level priority in the distribution scheme, (ii) claims arising from penalties in excess of actual pecuniary loss fourth level priority, and (iii) the payment of interest at the legal rate fifth level priority. The result of this subsection is that untimely claims are given a different treatment in a chapter 7 liquidation than a chapter 11 liquidation. Similarly, claims for penalties are subordinated in chapter 7, but not subordinated in chapter 11. And, in the context of a solvent chapter 7 debtor, interest is awarded to creditors at the legal rate. In some cases, courts have applied the best interests test to apply section 726 principles to a chapter 11 case.[9] However, in other circumstances, courts have found the best interests test inapplicable.[10]

certainly not precluded from proceeding pursuant to § 544 to recover the estate's deficiency under applicable state partnership law."). In addition, even if the debtor in possession cannot bring such a claim, creditors, arguably, may not be harmed to the extent they can continue to pursue general partners under applicable state law.

[8] *See, e.g., In re Roamer Linen Supply, Inc.*, 30 B.R. 932, 934 (Bankr. S.D.N.Y. 1983) (rejecting debtor's assertion "that this Chapter 11 case has all the indicia of a liquidation under Chapter 7 so as to justify the application of Code § 724(b)" and explaining that "[h]aving chosen Chapter 11 as their basis for relief, the debtors cannot now be heard to say that they would like to select helpful provisions from Chapter 7 which are expressly made inapplicable to reorganization cases under Chapter 11.").

[9] *See, e.g., Kitrosser v. CIT Group/Factoring, Inc.*, 177 B.R. 458, 469 (S.D.N.Y. 1995) (in the context of awarding post-bankruptcy interest, noting "[a]lthough the requirements of Chapter 7 are in general not applicable to Chapter 11 proceedings, *see* 11 U.S.C. § 103(b), Section 726 does apply through the requirements of Section 1129"); *In re Friedman's, Inc.*, 356 B.R. 766, 777 (Bankr. S.D. Ga. 2006) ("Section 1129(a)(7)(A) requires a bankruptcy court in confirming a plan to find that general unsecured claimants either (i) have accepted the plan or (ii) will receive as much under the Chapter 11 plan as they would receive in a hypothetical Chapter 7 liquidation. To meet that latter test, Section 726(a)(4) must be applied, with the result that all penalty/punitive claims are subordinated.")

[10] *See, e.g., In re Morande Enters., Inc.*, 07–cv–498, 2008 WL 4459143, *5 (M.D. Fla. Sept. 30 2008) (noting that the *Friedman*'s decision on the interplay between section 726(a)(4) and 1129(a)(7) was

Subsection (b) of section 726 is also noteworthy. This subsection provides that administrative expenses incurred in a chapter 7 are given priority over administrative expenses incurred in a chapter 11 case before conversion of the case. This section does not apply in a chapter 11 and, thus, creates an asymmetry when a chapter 11 debtor abandons efforts to reorganize through chapter 11 and switches its focus to liquidation. In such cases, there is, arguably, no express statutory authorization to prefer liquidating chapter 11 expenses (*i.e.*, burial costs) to operating chapter 11 expenses. Nonetheless, with the approval of the secured lenders under a section 506(c) surcharge theory, several courts have recognized the practical necessity of doing so and have entered wind down orders that bifurcate liquidating administrative expenses from operating administrative expenses.[11] Accordingly, this represents one example where chapter 7 practice appears to influence chapter 11 case law.

The Committee recommends that, with certain modifications, section 726 should apply under the Liquidation Option. Specifically, the Committee submits that the recognition of tardily filed claims under section 726(a) should not indefinitely delay distributions to other creditors with allowed claims; accordingly, the Committee recommends that section 726(a) be amended in the Liquidation Option so that claims tardily filed will be disallowed if filed after (i) confirmation of the plan of liquidation if the debtor confirms a plan or (ii) the record date established for the first set of distributions is made from the estate if the debtor will proceed without a plan. The Committee also recommends that "the legal rate" set forth in section 726(a)(5) be changed to "the contract rate if a contract exists, otherwise the federal judgment rate." The Committee was split regarding whether the "the contract rate" be read to include any default rate of interest and seeks the views of the full Conference on this topic. Finally, the Committee recommends that section 726(b) should apply to the Liquidation Option – that is, administrative expenses incurred after the effective date of the Notice of Election should be afforded higher priority than those incurred prior to the Election. In addition, the US Trustee and professional fee carve-outs established in a DIP financing order and/or cash collateral order will be maintained and enforced after the effective date of the Notice of Election.

4. Sections 701 – 704 and 1104 – 1106 of the Bankruptcy Code

Section 1104 of the Bankruptcy Code applies in a chapter 11 case only and sets forth rules and procedures for seeking the appointment of a trustee or an examiner, which appointment is not mandatory. Conversely, sections 701 through 704 of the Bankruptcy Code address the mandatory appointment of a trustee once a chapter 7 case is filed or a chapter 11 case is converted to one under chapter 7.

unpersuasive and *dicta*), *op. amended*, 2008 WL 4620725 (M.D. Fla. Oct 15, 2008). *See generally In re Xpedior Inc.*, 354 B.R. 210, 225 (Bankr. N.D. Ill. 2006) ("Section 726 should only be applied to cases under Chapter 7. … Thus, late-claims heretofore barred should not be entitled to a 'subordinated priority' or receive any distribution from the Debtors' Chapter 11 estate pursuant to Section 726.").

[11] *See, e.g., In re Hostess Brands, Inc.*, No. 12-22052 (Bankr. S.D.N.Y. Nov. 30, 2012)*; In re The Caldor Corp.*, 240 B.R. 180, 188-89 (Bankr. S.D.N.Y. 1999), *aff'd*, 266 B.R. 575 (S.D.N.Y 2001); *see, e.g., also* Order, *In re LTV Steel Co., Inc.*, No. 00–43866 (Bankr. N.D. Ohio Feb. 11, 2003).

Because the purpose of the Liquidation Option is to streamline a debtor's liquidation after attempts to reorganize have failed and to allow creditors significant input in the process, the Committee recommends that, once the procedure set forth in the Notice of Election is confirmed either by the passage of time with no objection or by the entry of an order of the Bankruptcy Court if the proposed procedures set forth in the Notice of Election are contested, the provisions of sections 1104(d) and 1106(b) in respect of examiners shall become inapplicable in the case. If the Bankruptcy Court has ordered the appointment of a chapter 11 trustee or an examiner before this time, such appointment shall not be disturbed.

In addition, the Committee recommends that the option for appointing a chapter 11 trustee under section 1104 of the Bankruptcy Code continue even after the Liquidation Option has been triggered. Inasmuch as the Liquidation Option will derive from a business that has been in chapter 11, the Committee recommends that the standards of sections 1104-1106 apply to the appointment of any trustee after the Liquidation Option is in effect. That is, in particular, sections 701 (regarding panel trustee) through 704 will not apply, with one caveat. That caveat is that the Committee recommends adding the duties of section 704(a)(1) to the list of duties enumerated in section 1106(a)(1).

5. Section 1111(b) of the Bankruptcy Code

Section 1111(b) of the Bankruptcy Code similarly only applies in a chapter 11 case. That section provides that nonrecourse debt is treated as having recourse unless either the class of secured debt makes an election or the property is sold pursuant to section 363 or is to be sold under a plan. While section 1111 applies only in a chapter 11 case, one might argue that in most liquidating chapter 11 cases, the general rule that non-recourse claims would be treated as recourse would be swallowed by the exception. In other words, in a liquidating chapter 11 case, the property will be sold and, thus, the secured creditor's claims would be treated as non-recourse. Accordingly, section 1111(b) creates another difference between the two chapters, but such difference is limited in the Liquidation Option context by operation of the sale exceptions.

The Committee, therefore, recommends that section 1111(b) should not apply under the Liquidation Option.

6. Sections 1113 and 1114 of the Bankruptcy Code

Section 1113 of the Bankruptcy Code regarding rejection of collective bargaining agreements also applies only in a chapter 11 case[12] and is perhaps one of the principal differences between the two chapters. Section 1113 contains certain requirements for rejection that do not apply in a chapter 7 case. Moreover, while the section 365 standard for rejection of CBAs applies in a chapter 7 case, section 1113 imposes a different standard for rejection in a liquidating chapter 11 case.[13] One may debate whether the results reached with respect to the rejection of CBAs in liquidating chapter 11 cases differ materially in practice than the results reached in chapter 7 cases. However, the applicability of section 1113 to chapter 11 cases remains one of the important differences between the two chapters.

Similarly, as with section 1113, there is no analogue in chapter 7 to section 1114 of the Bankruptcy Code.[14] That section addresses the payment of benefits to retired employees. Section 1114(e) of the Bankruptcy Code, for example, provides a general rule that the debtor in possession must timely pay retiree benefits (absent modification) and that such payments are treated as administrative expenses. The asymmetry created by section 1114's application to a chapter 11 liquidation and not a chapter 7 liquidation may be mitigated by actual modification of retiree benefits in chapter 11. In order to minimize discrepancies between the two chapters, however, the modification would have to be prompt. We note that, in most cases, the asymmetry between the two chapters could not be completely eliminated because the modification of retiree benefits could not as a practical matter be accomplished on the first day of the case. As such, where all other things are equal, retirees will likely do better in a chapter 11 liquidation than a chapter 7 liquidation.

The Committee recommends that sections 1113 and 1114 should not apply under the Liquidation Option. Further, once the Liquidation Option is triggered, the estate's obligation to pay benefits for retirees should automatically be suspended upon the later to occur of (a) the last day of the month following a month in which the Notice of Election is filed, or (b) the last of the of the month following the entry of the Liquidation Process Order.

7. Section 1146

Section 1146(a) of the Bankruptcy Code provides relief in chapter 11 from a "stamp tax or similar tax." Section 1146(b) authorizes the proponent of a chapter 11 plan to request a determination from state or local taxing authorities of the tax consequences of any plan under

[12] *See, e.g., In re Rufener Constr., Inc.*, 53 F.3d 1064, 1068 (9th Cir. 1995) ("Reading the language of § 1113 in its entirety, we conclude that it is applicable only to bankruptcies filed under Chapter 11."); *In re Moline Corp.*, 144 B.R. 75, 79 (Bankr. N.D. Ill. 1992) (noting "[o]f course, if the case fails and is converted to Chapter 7, § 1113 does not apply."), *leave to app. denied by*, No. 91 B 8873, 1992 WL 245669 (N.D. Ill. Sept. 17, 1992).

[13] *Compare* 11 U.S.C. § 1113 *with* 11 U.S.C. § 365; *see also NLRB v. Bildisco*, 465 U.S. 513 (1984).

[14] *See, e.g., In re Ionosphere Clubs, Inc.*, 134 B.R. 515, 521 (Bankr. S.D.N.Y. 1991) ("[T]he conclusion is inescapable that § 1114 is not applicable in Chapter 7").

chapter 11. Courts have held that section 1146 applies to liquidating chapter 11 cases.[15] However, nothing in chapter 7 provides similar rights for the proponents of a chapter 7 liquidation. As such, section 1146's application to chapter 11 liquidations would seem to make at least two material tax differences (evidenced by section 1146(a) and section 1146(b)) in the treatment between sales made pursuant to a liquidating plan[16] and those made by a chapter 7 liquidating trustee.

In its decision in Piccadilly Cafeterias, the United States Supreme Court adopted a literal interpretation of section 1146(a) and held that the exemption from stamp and similar taxes only applied in that narrow circumstance when a transfer of property occurs "under a plan confirmed" under chapter 11. Sales that occurred during the chapter 11 case were not subject to exemption. Under Piccadilly, courts are free to conclude that the various debtor rights in section 1146 do not apply to a chapter 7 liquidation. Since sales made pursuant to a liquidating plan closely resemble in many respects sales made by a chapter 7 trustee or sales made in a chapter 11 case before the confirmation of a plan, one may question why sales made pursuant to a liquidating chapter 11 plan should receive more favored tax treatment. [17]

The Committee believes that uniformity should exist in all cases of sales of substantially all of a debtor's assets (or in cases of an internal corporate restructuring where certain of the restructuring transactions are technically sales under state law) – whether in chapter 7 or chapter 11 and whether pursuant to a plan or otherwise. In short, the Committee recommends that the scope of section 1146(a) should be broadened to cover all sales in chapter 11 and chapter 7 of substantially all of a debtor's assets, including in the Liquidation Option, (or in cases of an internal corporate restructuring where certain of the restructuring transactions are technically sales under state law), or the provision should be scrapped in its entirety. If the provision is maintained, the Committee recommends that the section 1146(a) exemption should apply to state sales taxes as well as to 'stamp tax[es] or similar tax[es]."[18] Finally, the Committee recommends

[15] *See, e.g., State of Maryland v. Antonelli Creditors' Liquidating Trust*, 123 F.3d 777, 785 (4th Cir. 1997) (applying section 1146 to chapter 11 liquidating trust); *In re Smoss Enters. Corp.*, 54 B.R. 950, 951 (E.D.N.Y. 1985) (holding section 1146 applicable to liquidating plan).

[16] We note that sales made in a liquidating chapter 11 that are made before a plan is confirmed do not enjoy the protections of section 1146. See *Florida Department of Revenue v. Piccadilly Cafeterias, Inc.*, 554 U.S. 33, 52 (2008).

[17] The legislative history of section 1146 dates back to the 1930s; it appears that the provision was enacted at the same time as several other pro-taxpayer provisions were enacted (mostly dealing with debt cancellation income). An argument exists in support of the exemption because, under most bankruptcy cases, the transfer of property is not voluntary. The debtor does not want to sell, and the creditor does not want to own. In other words, but for the debtor's financial predicament, a sale would not have been contemplated. Thus, whereas most sales are between a willing buyer and a willing seller, a bankruptcy transfer involves neither of those. Therefore, a tax imposed by a state or county on the transfer would appear to be a windfall to the taxing jurisdiction. It is reasonable that the Bankruptcy Code would conclude not to extend a windfall to the tax collector. On the other hand, one could question whether a tax exemption from state stamp taxes should be granted at all. The Committee believes that the full Conference should discuss this as a matter of policy.

[18] At the November 13, 2014 annual meeting of the National Bankruptcy Conference, the Conference voted to keep the tax exemption set forth in section 1146(a) of the Bankruptcy Code and voted in favor of the proposition that the exemption should apply to sales of substantially all assets in both chapter 7 and chapter 11 cases, and,

that the provisions of section 1146(b) should be made uniform and be available in all the foregoing circumstances as well (*i.e.*, that a chapter 7 debtor should be able to obtain a determination of its tax liability in the same manner as a chapter 11 debtor may seek such determination under section 1146(b)).

Conclusion

The Committee recommends that the Bankruptcy Code be amended to include the Liquidation Option for the reasons stated above. Simply eliminating either chapter 7 or chapter 11 as an option for a liquidating debtor in order to promote parity was viewed by the Committee as a drastic and ill-advised fix. By the Liquidation Option, the Committee proposes to (i) build upon current law and practice, (ii) codify certain *ad hoc* practices that currently occur in practice when liquidating corporate debtors, (iii) harmonize provisions of chapter 7 and chapter 11 that affect liquidating corporate debtors and (iv) provide another, more flexible option for liquidating corporate debtors.

further, in chapter 11 cases regardless of whether or not the sale is effected pursuant to a plan. It was noted by Conferee Goldstein that section 1129(d) of the Bankruptcy Code should be amended to note this result.

Additional NBC Committee to Rethink Chapter 11 Reports: Reconsideration of Role of Official Committees of Unsecured Creditors

Memorandum

From: Marcia L. Goldstein
Thomas Moers Mayer

Re National Bankruptcy Conference's Committee to Rethink Chapter 11:
Reconsideration of Role of Official Committees of Unsecured Creditors

Background[1]

While official committees of unsecured creditors (each, a "***Creditors' Committee***") generally are considered to be a fundamental part of chapter 11 cases, it was not until 1986 that Creditors' Committees fully assumed their current form (*i.e.*, appointed by the U.S. Trustee rather than the bankruptcy court itself).[2] Informally, creditors' committees have existed since the earliest days of the Republic[3] and certainly since the enactment of the Bankruptcy Act of 1898, with case law from that period acknowledging such committees' benefit to bankruptcy cases under certain circumstances but also indicating uncertainty as to scope of committees' authority in representing other creditors. Despite the long history of committees in the bankruptcy process, chapter 11 has evolved through the years, and the time is ripe for a reconsideration of Creditors' Committees' role in chapter 11 cases.

[1] The background material on Creditors' Committees is drawn from the following sources: Kenneth N. Klee and K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995 (1993); Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge As Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431 (1995); Harvey R. Miller and Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153 (2004); Harvey R. Miller and Shai Y. Waisman, *The Future of Chapter 11: Is Chapter 11 Bankrupt?*, 47 B.C. L. REV. 129 (2005); Michelle M. Harner, *The Search for an Unbiased Fiduciary in Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469 (2011).

[2] Under the Bankruptcy Code prior to 1986, bankruptcy courts appointed Creditors' Committees, but in districts where Congress established the U.S. Trustee on an experimental basis, the U.S. Trustee had authority to appoint the Creditors' Committee. The Bankruptcy Code was amended in 1986 to provide for the U.S. Trustee's appointment of Creditors' Committees.

[3] *See* Burd v. Smith, 4 U.S. 76 (Pennsylvania 1802), which describes the formation of a committee on December 15, 1796 to report on a conveyance of real estate by one B. M'Clenachan, insolvent, to trustees for the benefit of his creditors in return for compelling creditors to release their claims. M'Clenahan owed $435,073 – in 1796, an enormous sum of money (under some measures $16.5 billion in 2013). http://www.measuringworth.com/uscompare/relativevalue.php

The earliest committees could be (and often were) individuals known to many creditors and selected by them to administer assignments for the benefits of creditors. The principal role of such committees was to oversee the sale of the insolvent's assets and the distribution of proceeds to creditors.

As businesses became larger and issued tradable bonds to widely disbursed creditors, committees became "protective committees" – collections of institutions or individuals who asked bondholders to deliver their bonds to the committee under "deposit agreements" giving the committee authority to negotiate reorganization on behalf of the holders. Each holder received "certificates of deposit" representing a tradable interest in its bonds, but the holder effectively gave up all rights as a bondholder to the committee, retaining only the right to withdraw its bonds after receiving notice of the plan negotiated by the committee. The "deposit agreements" gave the protective committee enormous power (including, often, the power to borrow against the bonds) severely limited by contract the duties owed by the committee to its bondholders:

The principal role of those committees was to negotiate the exchange of existing publicly traded debt securities for new debt securities or new equity securities.

While creditors' committees were recognized statutorily in the 1933 amendments to the Bankruptcy Act, where they were permitted supervisory or other control over the debtor's business in cases in which the debtor received an extension of time to pay its debts, Congress authorized the newly-formed Securities and Exchange Commission to investigate protective committees out of concerns that the committees were captive to the debtor's management or to the underwriters who had sold the bonds and were not serving the interests of the bondholders they purported to "protect", leading to SEC Commissioner Douglas' eight-volume report on Protective Committees and Trust Indentures and the Chandler Act of 1938, which contained the first statutory recognition, and regulation, of creditors' committees.

The Chandler Act of 1938 recognized creditors' committees in both Chapter X reorganizations of corporations with public debt and Chapter XI arrangements of other businesses. Chapter X committees were groups of creditors who put themselves forward as representatives of one or more classes of bonds. In Chapter X, the role of the committee, which did not have standing in the case, was limited to distribution of information to other creditors. Chapter XI featured one committee, which did have standing in the case, performed an oversight role, and had the power to advise and consult with the debtor as to administration of the estate, make recommendations to the debtor and submit questions to the court on the same. Creditors' committees that assisted in administration of the estate and helped develop or opposed the plan could petition the court for reimbursement of their expenses from the estate, including for payment of their professionals. Due to their permissive nature, however, creditors' committees depended on unorganized and unsophisticated creditor bodies organizing themselves to form a committee, which made such committees' participation in the bankruptcy process the exception rather than the rule.

Chapter XI initially was intended to restructure the unsecured debts of smaller businesses. Chapter XI was not available to businesses with publicly traded debt and had no power to affect either secured debt or equity. The Chapter XI committee's primary function was negotiating a composition (i.e., partial payment) or extension of debts through a plan of reorganization with the debtor, which often remained

in control of the business, or a court-appointed receiver. As businesses became increasing reluctant to use Chapter X, which was a cumbersome process intended for large public companies that required the mandatory appointment of a trustee, Chapter XI grew in appeal and importance. Due to certain of Chapter XI's constraints, however, a wholesale rethinking of the bankruptcy process was undertaken to address all aspects and types of distressed businesses.

The Bankruptcy Code emerged from nearly a decade of such rethinking, with Chapter 11 designed to comprehensively address corporate reorganizations of all types, with an emphasis on rehabilitation. The concept of the debtor in possession, which would remain in control of the business and serve as the estate's fiduciary, was the cornerstone of Chapter 11, and the Creditors' Committee, the unsecured creditors' fiduciary, was designed to perform the role of the debtor in possession's counterweight. In fact, the Bankruptcy Code makes appointment of a Creditors' Committee mandatory ("the United States trustee *shall* appoint a committee of creditors holding unsecured claims") (emphasis added).

The Bankruptcy Code itself and its legislative history demonstrate the counterweight role intended for the Creditors' Committee. The Creditors' Committee serves as the primary "watchdog" for the debtor in possession and the debtor in possession's primary negotiating counterparty in the plan formulation process.

The "watchdog" or oversight role includes consulting with the debtor in possession concerning the administration of the case, investigating the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business, and the desirability of the continuance of such business, the compensation of management or other insiders, and any other matter relevant to the case or to the formulation of a plan, requesting the appointment of a trustee or examiner, and performing such other services are in the interest of those represented. The Creditors' Committee may raise and appear and be heard on any issue in a case and has broad entitlements to notice in the Bankruptcy Code and Bankruptcy Rules.

The negotiating role includes many of these responsibilities (including negotiation of management compensation) as well as participating in the formulation of a plan, advising those represented by the committee of the committee's determinations as to any plan formulated, and collecting and filing with the court acceptances and rejections of a plan (although in large chapter 11 cases, a voting agent generally performs this role). In cases involving the recapitalization of debt into equity securities, the Committee's highest and best function is – or should be -- to negotiate terms by which current creditors become future shareholders, including issues such as the allocation of equity securities among classes of old debt and old equity, the rights of such securities, protections for minority shareholders, post-reorganization disclosure to shareholders, selection of post-reorganization directors and compensation or stock option plans for post-reorganization management

The dual roles of the Creditors' Committee, watchdog and negotiator, are acknowledged in the Bankruptcy Code's legislative history, which states that the Creditors' Committee (and any equity committee) "will be the primary negotiating bodies for the formulation of the plan of reorganization" and "will also provide supervision of the debtor in possession . . . and will protect their constituents' interests." These dual roles, and their interpretation by case law, recognize that a Creditors' Committee's fiduciary duty is to the unsecured creditors it represents (the Creditors' Committee does

not owe fiduciary duties to the estate, to which the debtor in possession owes fiduciary duties).[4] The Creditors' Committee's performance of its fiduciary duties generally entails the maximization of recoveries to unsecured creditors. This may conflict with the debtor in possession's performance of its fiduciary duties to maximize enterprise value of the business. Secured creditor interests may differ from both.

The current concept of Creditors' Committees, however, remains firmly rooted in financing structures of a prior time. During the formation of the Bankruptcy Code and in its enactment in 1978, the focus was on reorganizing and rehabilitating distressed businesses. An effective reorganization required that businesses restructure their financial obligations with both their lenders and their key suppliers, vendors, customers, and the like. The Code assumed that a Creditors' Committee would, in each case, take the lead in negotiating the terms of a restructuring that would later be submitted to a vote of creditors. While such restructuring is still necessary today, the parties involved have changed dramatically.

First, the last thirty years have seen a shift from unsecured financing to secured financing of businesses. Secured financing has grown increasingly sophisticated, with multiple levels, or tranches, of secured debt. Security agreements routinely cover substantially all assets of the debtors, giving secured creditors greater power of life or death over the business. The increasing dominance and predominance of secured creditors is illustrated by the debate in recent years over whether secured creditors are exerting too much control over chapter 11 cases. Indeed, the debate's focus on the struggle for control between debtors in possession and secured creditors often omits any discussion of unsecured creditors whatsoever. Where there is little or no unsecured debt, or where substantially all assets are pledged to secured lenders and the value of the estate is materially less than the secured debt, unsecured creditors have little economic standing. In such cases, the Creditors' Committee is left with powers of oversight and plan negotiation for an out-of-the-money-constituency whose recovery is not affected by either oversight or negotiation except to the extent such recovery is magnified by the Committee's access to estate-paid counsel and experts who can exact "hold-up" value from more senior interests at no cost to their own constituency.

In cases involving substantial amounts of in-the-money publicly traded unsecured debt, the major holders of such debt are reluctant to serve on a Creditors' Committee for fear they will be restricted from securities trading. Instead, the major holders act individually or as part of ad hoc committees. In such cases, the official Creditors' Committee has a constituency but limited ability to represent it in connection with major decisions (such as negotiation of the plan and securities to be issued under the plan) because the major holders will vote on the plan in accordance with their own analysis and with limited regard for different conclusions from the Creditors' Committee.

Against this backdrop, which is very different from the backdrop behind the Bankruptcy Code's enactment in 1978, we submit that it is time to consider limitations on the role (and even appointment) of Creditors' Committees in chapter 11 cases.

[4] *See, e.g.*, In re SPM Mfg. Corp., 984 F.2d 1305, 1315 (1st Cir. 1993).

Issue #1: Appointment and Scope of Creditors' Committees

The principal function of a creditors committee is to represent unsecured creditors who would not otherwise have representation and who have (or may have) real economic interests at stake.

The first condition is present when a debtor has a substantial body of trade vendors or other claimants, all of whom have relatively small claims comprising a minimal amount of the debtor's claims overall, that would otherwise be too dispersed and disorganized to take part in the bankruptcy process. Failure to appoint a committee to represent these holders would subvert the original intention of the committee process. However, there should be some materiality cut-off. Where unsecured claims are truly *de minimis*, the expense of a creditors' committee may outweigh any benefit to the disorganized creditors it represents. A threshold of $5 million, comparable to the current threshold for appointing an examiner, could be a logical place to start.[5]

Moreover, disorganized creditors should be distinguished from "organized creditors" – those who hold claims under a bank credit agreement, trust indenture or other agreement which empowers an institution to act on their behalf and be compensated and reimbursed for the costs of such action out of distributions otherwise payable to the creditors they represent. It makes no sense to appoint a committee to represent organized creditors at estate expense when an institution represents them at their own expense.

The second condition – real economic interests at stake -- is more complicated. It can be argued that a committee for out-of-the-money unsecured creditors is no more justifiable than a committee for out-of-the-money equity holders. That argument is too simple.

Many factors other than valuation may justify distributions to unsecured creditors, including possible avoidance of transfers or subordination or disallowance of claims. A principal function of a Creditors' Committee in many cases is to verify whether secured creditors' liens are actually valid, often because the debtor has agreed not to do so as a condition to obtaining financing (or consent to a financing) from secured creditors whose liens are at issue. This specific example illustrates a larger truth: where the debtor and secured creditors have agreed on the conduct of a case, the Creditors' Committee may serve as the one remaining party able to review such agreements and, where appropriate, serve as a necessary adversary to enable the court to act as a court and not merely a rubber stamp.

Moreover, a chapter 11 case with in-the-money equity is the rare exception, not the rule. Large chapter 11 cases are far more likely to provide some value to unsecured creditors than to equity holders. Therefore, we believe the standard for disbanding a Creditors' Committee on the ground that unsecured creditors are "out of the money" should be much tougher than the standard for denying a motion to appoint an equity committee.

Nevertheless, there are cases where the real economic interests of unsecured creditors would not justify the expense of a Creditors' Committee.

[5] Further thought can be given to this threshold in the context of small business bankruptcies.

For example, a sale of substantially all of the assets of the estate may establish value for the purpose of determining whether unsecured creditors are out of the money. While a Creditors' Committee should have standing to object to the sale, especially if it appears that a secured creditor is undervaluing the debtor's business to the detriment of unsecured creditors' potential recovery, the consummation of the sale would determine whether unsecured creditors have a stake in the case. Even where the sale produces proceeds for unsecured creditors, the final act of the case may be the resolution of disputes among unsecured creditors which a creditors' committee is too conflicted to resolve, in which case the committee's plan negotiation and oversight functions should be curtailed. We address unsecured creditor conflicts below.

Finally, where substantially all unsecured claims are trade claims, the purchaser of substantially all assets may agree to pay such claims, which may eliminate the need for a committee.[6]

We therefore recommend the following changes to the statute:

Section 101 should be amended as follows:

> ***The term "organized claims" means claims subject to a trust indenture, bank credit agreement or similar agreement under which an institution (a) may take actions for the benefit of such claims (b) will receive distributions on account of such claims and may deduct from such distributions such sums as are necessary to pay its reasonable fees and expenses and (c) will, pursuant to an order of the court, receive all distributions on account of the claims it represents.***

Section 1102(a)(3) should be amended as follows:

> (3) On request of a party in interest after a notice and a hearing ~~in a case in which the debtor is a small business debtor~~ and for cause, the court may order that a committee of creditors not be appointed, ***or may suspend the committee's operations or may disband the committee. Cause may include any of the following:***
>
> > ***(A) An order which approves a sale of substantially all property of the estate also provides that substantially all unsecured claims shall be paid in full (i) out of the proceeds of the sale upon consummation of the sale, or (ii) by a party other than the debtor upon consummation of the sale or in accordance with agreements governing such claims; or***
> >
> > ***(B) Fees and expenses to be incurred by the committee are likely to exceed proceeds remaining from a consummated sale or sales of substantially all assets of the estate after satisfaction of all liens, administrative expenses and claims entitled to priority under Section 507; or***
> >
> > ***(C) No sale of material portions of the estate is contemplated, the committee has completed its review of liens and exercised all rights which were granted to the***

[6] Where the only unpaid claims are litigation claims, contingency fee arrangements may provide litigation claimants with the same representation as agreements provide organized creditors.

committee pursuant to any order of the court, and either (i) the probable amount of all unsecured claims other than organized claims is less than $5,000,000 or (ii) there is no reasonable likelihood of a material distribution on unsecured claims.

Upon request of a party in interest after notice and a hearing, the court may rescind any order previously denying appointment of, suspending operation of or disbanding a committee. Such relief shall be liberally granted for cause, and the movant shall be entitled to a rebuttable presumption that cause exists upon a prima facie showing of a material change in facts on which the previous order rested.

Issue #2: Committees and Post-Bankruptcy Trusts

In a number of recent cases, liquidating trusts and/or litigation trusts have been established as part of chapter 11 plans for the benefit of unsecured creditors, and it has become more common for Creditors' Committees to seek to have their professionals represent or serve as the liquidating or litigation trustees of such trusts. Such employment may lead to a conflict of interest between the Creditors' Committee's professionals and the best interests of unsecured creditors. Because the Creditors' Committee's professionals often negotiate the terms of the liquidating or litigation trust with the debtor in possession, the possibility of future employment by or as the liquidating or litigation trustee provides such professionals with a financial interest in the outcome of such negotiations, particularly negotiations over funding of the trusts and scope of authority. Professionals' judgment and decision making as to what is best for unsecured creditors may be impaired by their own conflicts of interest and divergent financial incentives. While a Creditors' Committee's professionals may be more familiar with the case and use such familiarity to gain employment by or as the liquidating or litigation trustee, this built-in advantage for the Creditors' Committee's professionals potentially eliminates a competitive selection process to the exclusion of an independent voice who may better represent the interests of trust beneficiaries.

The same observations apply to professionals retained by the debtor-in-possession.

Therefore, to avoid the conflicts of interest inherent in a Creditors' Committee's professionals or a debtor in possession's professionals representing a liquidating or litigation trust, we recommend the Code be amended as follows:

Section 329 shall be amended by inserting the following paragraph (c):

(c) If in any case under this title an entity is established to liquidate assets, distribute proceeds or pursue litigation, no professional previously paid out of the estate may represent such entity unless the court, after notice and a hearing, finds that (i) the process to select such professional was open to competitive bids from outside professionals, (ii) such bids have been disclosed, and (iii) the professional proposed to be retained by such entity is the best choice for such entity based on cost, efficiency, quality and reputation of professional and such other factors as the court deems relevant.

Issue #3: Intercreditor Conflicts (Liens, Subordination, Claims Trading) and Disclosure

Creditors' Committees often include individual creditors whose interests conflict with other creditors, the following being common examples:

- An unsecured creditor with a large unliquidated claim may have an interest in allowing such claim at its maximum amount in conflict with other creditors generally – e.g., tort claimants, or creditors with large rejected contracts.

- An unsecured creditor with a large executory contract (e.g., a union or the Pension Benefit Guaranty Corporation) may be interested in the assumption (perhaps with modifications) of the contract, potentially to the detriment of all other unsecured creditors. (The converse is occasionally true: a creditor may have an interest in the impairment of its contract, and its receipt of consideration in cash, stock or other value in excess of the value of its debt if reinstated, as happened in Smurfit Stone Container Corporation and may have happened in Delta Airlines.)

- Members of a Creditors Committee may negotiate a rights offering which diverts value from unsecured creditors generally into the pockets of rights offering participants including the individual committee members, as happened in Dana Corporation (and could have happened in Dura Automotive Corporation).

- In a multi-debtor case, the U.S. Trustee routinely appoints one Creditors' Committee to represent creditors of all debtors. Some debtors are asset-poor, some are asset-rich. Members who hold claims against an asset-poor debtor will have an interest in substantively consolidating with asset-rich debtors in conflict with the interest of those debtors' creditors; members holding claims against asset-rich debtors have the opposite conflict. Which position the Committee supports becomes a function of its membership.

- A trade creditor who sits on a Creditors' Committee for the purpose of increasing the business it does with the Debtor may not act to increase the recovery of unsecured creditors it is supposed to represent.[7] Such a creditor may support reorganization even if liquidation will clearly yield superior returns to unsecured creditors. The trade creditor dependent on the Debtors for future business may support management compensation plans for fear of angering the executives with whom it routinely does business.

- Senior unsecured creditors who sit on a Creditors' Committee may have an interest in a low enterprise value of the Debtors to the detriment of junior creditors; junior unsecured creditors may have the opposite interest. The interest of senior unsecured creditors in a low enterprise

[7] A small individual bondholder may pose the same problem – especially where reimbursement of Committee expenses provides him or her with more benefits (travel, hotel and meals) than recovery on his or her bond position.

value is potentially dangerous because it dovetails with the interests of continuing managers, who will negotiate for stock in the reorganized debtor at a low value and stock options struck at a low value.

- An unsecured creditor who sits on a Creditors' Committee may hold secured debt, equity, derivative interests or credit insurance that creates a conflict. Rule 2019, which requires informal committees to disclose such interests, excludes Creditors' Committee members from most of its requirements, even though there is at least one celebrated case where a Committee member lied to the U.S. Trustee about a short position which diminished its real interest in unsecured bonds to almost nothing.[8]

Creditors' Committee conflicts are difficult but not impossible to police. We propose the Bankruptcy Code and/or Rules be amended as follows:

- ***Rule 2019 should provide for Creditors' Committee members to publicly disclose all intercreditor agreements, subordination provisions and "economic interests" upon their joining the Committee and any material change in their holdings within five business days of such change***. We suggest a 5% change would be material.
- ***Rule 2019 should provide (for both official and unofficial committees), that disclosure is required across all debtors and all affiliates of the creditor; provided, that where a creditor holds claims against one or more debtors through different entities, divisions or "desks" (collectively, "desks"), lists holdings of less than all of such desks in its application to serve on a Creditors' Committee (or its rule 2019 filing with respect to an unofficial committee) and maintains an ethical wall separating the Committee desk or desks from the other desks, then the creditor need not disclose holdings managed by such walled off desks***.
- ***To encourage large security holders to serve on Committees, the Code should be amended to provide a safe harbor from liability for trading under either the Bankruptcy Code or the securities laws so long as the member has maintained an ethical wall as prescribed in the statute. The statute should prescribe minimum conditions for maintenance of an "ethical wall" based on the SEC's No-Action Letter in the Allied Stores case and the "trading wall"orders entered in cases since.***
- ***The Code should require each Committee member to disclose publicly the amount of its expenses reimbursed by the Debtors***.

- ***The Code or Rules should prescribe a model set of by-laws for each Official Committee, with changes permitted only upon leave of court for cause shown on notice to all creditors***. The by-laws should require each committee member with an interest in any transaction, including specifically any rights offering, to recuse itself from a vote by the Committee. Each pleading

[8] In the Matter of Van D. Greenfield and Blue River Capital LLC, Administrative Proceeding File No. 3-12098, Securities and Exchange Act of 1934 Release No. 52744, 2005 SEC LEXIS 2892 (November 7, 2005) at ** 12-13 (¶ 21)..

filed by the Committee should disclose whether any member recused itself from a vote in connection with such pleading. The by-laws should require a member to resign if a majority of its claims have been sold, paid or assumed unless the Court, on motion by such member or the Committee, allows the member to remain on the Committee for cause shown. The by-laws should also contain confidentiality provisions and the Code should require the Debtors to provide information to the Committee in reliance on such confidentiality provisions unless the Court orders otherwise.

- ***The Code or Rules should provide that where the Committee takes a position on an issue creating a conflict among creditors generally, such as substantive consolidation or enterprise valuation prejudicing a creditor, any creditor (including, without limitation, any Committee member) may promptly move to bar the Committee from advocating its position and the Court may grant such motion if the Court determines either that the Committee's composition has unfairly affected its position on such issue or that the Committee's advocacy is not likely to assist in the resolution of the issue; provided, that the Committee may advocate support or opposition to any proposed settlement***. This provision would discourage the use of the Committee by one creditor faction or another to advance that faction's goals and will discourage the Committee from intervening reflexively on issues that will not benefit from its participation.

Issue #4: Creditors' Committees and Examiners

Finally, a clearer distinction should be drawn between the responsibilities of a Creditors' Committee and an examiner. Currently, both the Creditors' Committee and the examiner are empowered to investigate the prepetition conduct and transactions of the debtor. Generally, the Creditors' Committee's and examiner's professionals perform these investigations. As both the Creditors' Committee's and examiner's professionals are paid from estate funds, this duplication is wasteful. ***Where the order appointing an examiner specifies certain aspects of the debtor's business or certain of the debtors' transactions for the examiner to investigate, the Creditors' Committee should, in the absence of cause shown, be precluded from investigating such aspects of the debtor's business or such transactions. In addition, where an examiner is appointed after the Creditors' Committee already has commenced an investigation on the same subject matter, the Creditors' Committee's investigation should cease in the absence of cause shown, and the Creditors' Committee should turn over (under the auspices of common interest) all materials, including work product, regarding its investigation to the examiner to avoid any duplication of efforts.***

Additional NBC Committee to Rethink Chapter 11 Reports: Section 363 Sales and DIP Financing

NATIONAL BANKRUPTCY CONFERENCE

Report

of the

Committee to Rethink Chapter 11

on

Section 363 Sales and DIP Financing

Mid-Year Meeting April 9, 2013

Introduction

This report reviews, examines, and sets forth proposals concerning sales under section 363 of the Bankruptcy Code, DIP financing, and cash collateral.

I. Section 363 Sales

Going-concern sales and reorganizations are two different ways to sort out the affairs of a financially distressed business. In some instances the best path is a sale to a new owner. In other instances, it will be a recapitalization. Unfortunately, the Bankruptcy Code was not written with the idea that sales could be an effective alternative to reorganization in many cases. The procedures it sets out for a sale under section 363(b) of the Bankruptcy Code (each, a "***363 Sale***") are massively underdeveloped and are subject to abuse. A sensible reform of the Bankruptcy Code would both put procedural protections in place and at the same time minimize the incentives of parties with control to choose a 363 Sale or reorganization on the basis of what advances their individual interests, rather than the interests of everyone as a group.

The Bankruptcy Code was also written at a time when unsecured debt was the fulcrum security in the typical case. Many parts of the Bankruptcy Code, from the treatment of administrative expenses to the creditors' committee structure, were written with this assumption in mind. In today's large cases, the secured creditors are often the only ones in the money. It should not be troubling that the typical beneficiaries of bankruptcy will be secured creditors. There is no great conceptual difference between a firm that has a capital structure with ordinary debt and subordinated debt; a firm that has a capital structure with secured and unsecured debt; and a firm with senior secured and junior secured debt. Equity receiverships commonly consisted of multiple tiers of secured debt. Nevertheless, the rise of secured debt may require changes in the Bankruptcy Code, as again the Bankruptcy Code was written under the assumption that the unsecured creditors would typically hold the fulcrum security.

In short, as long as a commitment to the absolute priority rule is maintained, it should not be too troubling if a firm is sold or reorganized and the only parties who receive anything are secured creditors. The precise shape of the capital structure should not affect the choice of whether to sell or reorganize the firm. Choosing between a 363 Sale and reorganization requires asking

which yields the largest pie for distribution to whomever is entitled to receive it. It has nothing to do with how the pie is sliced or whether any of those entitled to a slice are secured.

The differences between sections 363(b) and 1129 of the Bankruptcy Code come primarily from two sources. First, section 363 is massively underdeveloped. It contains no protections or standards as to how the sale should be conducted. Beyond the right to notice and a hearing, there are no procedures comparable to those in chapter 11, and especially section 1129, to protect dissenting parties. Second, and analytically different, section 363 is focused entirely on the sale itself and not on who gets what. In contrast to section 1129, it does not touch the issue of how the proceeds will be distributed or how anything will be paid for.

Accepting the importance of a 363 Sale as an independent way of restructuring firms requires more than simply folding going-concern sales into the existing plan confirmation process. There need to be procedures focusing on the sale itself. The existing provisions of chapter 11 do not do this as they are designed under the assumption that the ultimate backstop is a judicial valuation rather than a market sale. That said, the distributional outcomes should not change depending upon which avenue is chosen. Where there is overlap between the rules put in place in section 363 and the traditional reorganization process, they should track each other. The different wording in sections 363(f) and 1141 invites unnecessary difficulties. The scope of the discharge, for example, should be constant, regardless of whether there is a 363 Sale. The ability to reshape collective bargaining agreements should similarly be the same, regardless of which avenue is used.

A reshaped Bankruptcy Code that expressly contemplates going-concern sales should confront a number of issues on which section 363 is silent. Section 363 says nothing as to what standard should be used to decide whether or how a sale should be conducted. It is conspicuously silent about, among other things, whether and to what extent non-cash bids can be accepted. There are no time periods comparable to those in section 1121 to provide presumptions as to how much notice must be given or when and under what circumstances another party can propose a 363 Sale. Moreover, there is nothing comparable to the "best interests of the creditors" test under section 1129(a)(7) to protect dissenting creditors. Section 363 is also silent as to how the sale is to be paid for. There is nothing comparable to section 1129(a)(9)(A).

Traditional reorganizations work with classification rules that give greater rights of review when those similarly situated oppose a plan. Section 363 provides no such enhanced powers. That said, it is not obvious that there should be. These provisions may be necessary in a traditional reorganization precisely because there is no market sale and instead an expensive judicial valuation. The question of whether a 363 Sale can be done effectively may be a binary one. If it can be done effectively, it should bind everyone. If it cannot be, arguably it should not take place at all.

Section 363 provides for no distributional rules. Once the proceeds are collected, the implicit assumption is that whatever is received will be distributed later under a plan or in a liquidation. There are, however, several ways in which distributional consequences follow in the wake of a 363 Sale. First, whenever a court allows credit bidding, it is making some assessment as to the validity of the lien. Whenever the lien covers only part (even if it is the major part) of the assets

of the company, one is making implicit decisions about distribution. In addition, parties to the 363 Sale may try to include amounts to be paid to prepetition creditors in an order entered in conjunction with the sale. Parties can also couple the sale order with a motion to convert to chapter 7, which again has distributional consequences.

The amount of oversight a 363 Sale requires depends in some measure on the circumstances. A situation in which the senior lender who is owed $500 presses for a sale of everything for $100 is in this respect much easier that one in which the senior lender is owed $100 and is pressing for a sale for $100. In the first case, there is strong reason to believe that only the senior lender is in the money. If money is being left on the table, it is the money of the senior lender. The sale does not need to be scrutinized as much because if it is a bad idea, the senior lender is the one bearing the consequences. By contrast, if the results of a quick sale are coming very close to paying the senior lender in full, the concern may arise that it is a fire sale that is not maximizing value. A similar concern may arise if the sale is one in which the senior lender is going to end up with the business or when insiders are the stalking horse bidders.

With this in mind, this section of the report outlines some of the issues in sections 363(b) and 363(f) of the Bankruptcy Code and sets forth proposals for addressing these issues.

- ***Issue #1: Relevant Test for Approval a 363 Sale.*** The question has arisen as to whether the relevant test for approval of a 363 Sale should be the business judgment test of *Comm. of Equity Sec. Holders v. Lionel Corp. (In re Lionel Corp.),* 722 F.2d 1063, 1066 (2d Cir. 1983) or something else. As proposed below, the answer is "something else."

    - ***Proposal:***

        - In deciding whether to approve a 363 Sale, the court should not defer to the business judgment of the debtor. Rather, the court should make an independent assessment of whether the proposed sale is the course that maximizes the value of whatever is being sold for the benefit of the estate. The burden of proof should remain on the proponent of the sale. While the proponent need not show that the business or assets are "melting" in order to justify the sale (except as discussed below in *Issue #2 (Appropriate Timing for a 363 Sale)*), he would have to demonstrate that a sale of the business or assets – in the time frame proposed and in the manner proposed – is in the best interests of the estate (the "***363 Sale Standard***").

        - The 363 Sale Standard is a stronger standard than *Lionel*, as the sale proponent has to do more than show that there is a sensible business reason for the sale. The proponent must affirmatively demonstrate that it is a good idea for all concerned – *i.e.*, that a sale, in the time frame proposed and in the manner proposed, is in the best interest of the estate.

        - The benchmark for testing the reasonableness of the manner proposed for the sale should be that the sale is being conducted in a fashion that is consistent with the way a prudent person would do it if trading on his own

account. If a seller would take some period of time searching for a buyer outside of bankruptcy, a similar amount of time should be presumptively expected inside. Of course, the court can and should consider efforts made prior to the bankruptcy filing to market the assets. And, if those efforts were prudent, the postpetition requirements for further marketing, etc. can be modified accordingly.

- ***Issue #2: Appropriate Timing for a 363 Sale.*** While an outright prohibition of sales for a defined period of time might facilitate the debtor (and creditors) having the opportunity to meaningfully evaluate the prospects for a true reorganization of the debtor's business, an absolute prohibition of a sale is problematic. Certainly, if the asset is a melting ice cube, a sale before it completely melts is both appropriate and necessary. In today's environment, however, secured creditors with blanket liens often "force" a quick sale of the debtor's assets by refusing to lend monies other than those necessary to operate while a short sale process plays out.

    - ***Proposal:*** Impose a higher burden of proof during the early stages of a chapter 11 case. No order approving a 363 Sale can be entered during the first 60 days of the bankruptcy case, unless the proponent of the sale can demonstrate by clear and convincing evidence that the debtor will suffer an irreparable injury if there is no sale (the "***Irreparable Injury Standard***").[1] After that time frame, the burden of proof in connection with a motion for a 363 Sale would return to the lesser preponderance of the evidence 363 Sale Standard. This would have the effect of limiting rapid sales, particularly of substantially all of the debtor's assets. The idea is to retain flexibility but to make the 363 Sale process more akin to the plan confirmation process.

- ***Issue #3: Payment for the Bankruptcy Process in the 363 Sale Context.*** Those who benefit from the bankruptcy process should pay for it. Existing law places expenses after the claims of secured creditors, but this is a consequence of the Bankruptcy Code's assumption that the unsecured creditors would most often be "in the money." Now that this assumption no longer holds, this rule needs to be changed substantially. Given section 506(c), this should not be regarded as a dramatic change, but section 506(c) in its current form is too narrow.

[1] In addition, the Sale Threshold proposed in *Issue #1 (Forced Asset Sales) of Section II (DIP Financing/Cash Collateral)* provides a minimum amount of time that a 363 Sale hearing for substantially all of the debtor's assets can be set in a Financing Order (*e.g.*, 180 after petition date). The debtor would retain the ability to seek a 363 Sale hearing before the Sale Threshold in the event that a melting ice cube or emergency situation necessitates such sale, *provided* that the court may approve the sale only if the debtor satisfies the Irreparably Injury Standard for a 363 Sale during the first 60 days of the bankruptcy case. After the first 60 days of the bankruptcy case but before the Sale Threshold, the debtor may seek a 363 Sale hearing, with approval of the sale subject to the debtor's satisfaction of the 363 Sale Standard, but a Financing Order itself may not set a 363 Sale hearing before the Sale Threshold.

- ***Proposal:***[2]

    - The expenses of a 363 Sale should be deducted from the proceeds of the sale. *See* UCC 9-615(a)(1). These expenses do not correspond perfectly with the administrative expenses under section 503(b). For example, they would not include expenses for prepetition goods under section 503(b)(9). At a minimum, however, the cost of running the business while the sale of substantially all of the debtor's assets is being organized and consummated should be chargeable against the sale proceeds, as these expenses are charged against property when it is sold outside of bankruptcy. Moreover, the reasonable costs associated with running the bankruptcy case pending consummation of a sale should be chargeable against the proceeds of the sale. In those cases where the U.S. Trustee is successful in forming a creditors' committee, the reasonable fees and expenses of the committee and its professionals in connection with the case and the sale should be paid from the sale proceeds. While the secured creditor should enjoy the right to credit bid in all cases, he should nevertheless have to put up sufficient cash to pay these costs. These expenses may be fixed in advance in the same fashion as carve outs, including, for example, a budget for the debtor and the creditors' committee and a cap on the amount that the creditors' committee can expend on investigating the liens of the senior creditor. *See also Issue #8 (Impairment of Unsecured Creditor Rights) of Section II (DIP Financing/Cash Collateral).*

    - If the secured creditor does not want to pay for the costs of a bankruptcy process, it has other remedies – *i.e*., relief from stay, dismissal of the case, and, ultimately, its state law remedies – it can foreclose upon its collateral and then dispose of the assets as it sees fit for its own account. The practice of allowing a sale to go forward and then immediately allowing a conversion to chapter 7 and leaving expenses associated with the sale unpaid should not be permitted.

- ***Issue #4: Sale Process vs. Distribution Process.*** The 363 Sale itself should be conducted in a way that separates the sale process from the process that decides how the proceeds of the sale are divided up. This seems to be the basic idea at work in *Braniff*. *See In re Braniff Airways, Inc*. 700 F.2d 935 (5th Cir. 1983); *In re Continental Air Lines, Inc*. 780 F.2d 1223 (5th Cir. 1986).

    - ***Proposal:***

        - There should be a prohibition on the order approving a 363 Sale from specifying any particular distribution of the proceeds or resolving such

[2] This proposal does not consider individual chapter 11 cases or whether it would apply to small (or smaller) business debtors. This proposal also does not examine treatment of tax liabilities.

questions as avoidance actions. That should be left to a subsequent motion or other procedural device.

- Equally important, the 363 Sale procedures and the definitions of qualified bids should not limit the coin in which bids are made. Among other things, a bidder should always be able to make a straight cash bid and take the assets without being subjected to any limitations as to how the business should be run or what existing obligations need to be assumed.

- ***Issue #5: "Free and Clear" Nature of 363 Sales.*** The 363 Sale mechanism should be set up in a way to maximize the proceeds received. To the extent existing law is not clear, section 363(f) should be revised to make it plain that a 363 Sale can be done free and clear of claims and interests and be every bit as unencumbered as they would be if the firm were reorganized and there was a discharge under section 1141. *See In re Trans World Airlines*, 322 F.3d 283 (3d Cir. 2003).

  - ***Proposal:***

    - The addition of "claims" to the "free and clear" language of section 363(f) may be sensible, as it has led some courts to draw inferences from its absence. *See, e.g., Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) ("[g]eneral unsecured claimants including tort claimants, have no specific interest in a debtor's property" for purposes of section 363(f)). In addition, the difficulties some courts have experienced in interpreting the interaction between 363(f)(3) and (f)(5) should be addressed. *See, e.g., Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 Bankr. 25 (9th Cir. BAP 2008).

    - Again, the choice between confirmation of a plan and a 363 Sale of substantially all of the debtor's assets by motion should be based on what is best for the estate, subject to the constraints of due process and the like. There is no need to distinguish between the two. Regardless of whether the sale yields enough to pay off junior lienholders, the sale should be free and clear of their interest. This is the law outside of bankruptcy and there is no reason to have a different principle at work inside.

- ***Issue #6: Protection of Good Faith Purchasers.*** Good faith purchasers should be protected in the event the sale is consummated and no stay of the sale was obtained.

  - ***Proposal:*** Section 363(m) should be retained. Similarly, and as discussed below, section 363(n) should be retained. It protects the estate from collusive bidding.

- ***Issue #7: Collusion among Bidders***. Auctions work effectively only if bidders do not collude with one another. Under certain circumstances, however, a coalition of two bidders may be willing to make a higher bid than either one separately or any other bidder. Prohibitions against collusion should not prevent potential buyers from joining

forces when such a course would be in the estate's interest. Disclosure may provide the most sensible path to ensuring this outcome.

- ***Proposal:*** There should be no per se prohibition on contacts or discussions among potential bidders, but such contacts or discussions that do take place must be disclosed. With such a rule in place, parties would be more likely to engage only in those discussions that they are willing to talk about in open court. Moreover, section 363(n) should be retained.

- ***Issue #8: Accounting for Obligations Assumed by Buyers***. Competing buyers may have different plans for the business. One buyer may plan to continue the business as a going concern. For that buyer, it may make sense to pay some prepetition obligations. Another buyer may plan on liquidating the assets and not assuming any obligations. The judge must be able to compare these two competing bids or have a basis to evaluate a single bid that proposes to assume some prepetition obligations and have some rule for how much credit (if any) to give a buyer who assumes some prepetition obligations, when other buyers do not.

  - ***Proposal:***[3] The aim of the sale is to maximize the return to those who share in the distribution of the assets of the estate. Hence, when buyers propose to assume debts, they should be given credit only to the extent that, by doing so, they reduce claims against the estate and thereby increase the net recovery available to those who share in it. Thus, when the second lienors and general unsecured creditors are out of the money, a buyer who plans to assume some unsecured debt should not be seen more favorably than a buyer who plans to assume none. By contrast, when there is a distribution to general creditors, a buyer who assumes trade debt should be credited to the extent that those who are paid off no longer have claims against the estate.

II. DIP Financing/Cash Collateral

A chapter 11 debtor's ability to obtain DIP financing and/or use cash collateral is a crucial element in providing a debtor an opportunity to develop alternative strategies to maximize enterprise value for the benefit of all stakeholders.[4] Although the Bankruptcy Code contains numerous protections and incentives to encourage lenders to provide postpetition financing, the Bankruptcy Code provides few checks on lenders overreaching and exerting leverage to drive the chapter 11 process, often to the detriment of the estate and the debtor's other stakeholders. Due to the prevalence of companies granting lenders blanket liens over all their assets, prepetition secured lenders more often than not end up being the only lenders willing to provide postpetition financing to debtors. Postpetition financing proposals often come with onerous terms that result in the debtor losing the ability to control the course of the chapter 11 case and providing lenders

[3] This proposal does not address what obligations, if any, can be assumed.

[4] This is consistent with the Supreme Court's observation that the "fundamental purpose of reorganization is to prevent a debtor from going into liquidation . . . ." *NLRB v. Bildisco and Bildisco*, 465 U.S. 513, 528, 104 S.Ct. 1188, 1197 (1984).

with benefits they would not otherwise be entitled to outside of chapter 11. It is this "creditor-in-possession" phenomenon that has led to a proliferation of quick 363 Sales.

Although lenders should have incentives to provide postpetition financing, that must be balanced against the restructuring objectives of debtors and their stakeholders. This section of the report outlines some of the recurring issues that surface in DIP financings and use of cash collateral orders and sets forth proposals for addressing these issues. As reflected below, each of the proposals is aimed at balancing the goals of affording a debtor a fair chance to reorganize while being fair to the postpetition lenders and other secured creditors. In addition, many of the below proposals prohibit outright certain provisions in DIP financing orders and cash collateral orders (each, a "***Financing Order***") that are already disfavored by courts so that courts will not be placed in the difficult position of being forced to approve these provisions just to avoid the debtor losing its only source of postpetition financing. Anecdotal evidence shows that prohibiting these provisions outright should not negatively affect a debtor's ability to obtain postpetition financing. Moreover, the proposals set forth herein are intended to encourage, to the extent practicable, greater competition for the provision of postpetition financing.

- ***Issue #1: Forced Asset Sales.*** To avoid the risk of diminution in value of their collateral, secured lenders frequently prefer quick 363 Sales of substantially all of the debtor's assets to a prolonged chapter 11 case. Financing Orders increasingly contain deadlines for debtors to conduct 363 Sales of substantially all of their assets, often within a few weeks after the filing of a chapter 11 case. Such forced asset sales may preclude a debtor from formulating alternative business plans. The estate may also receive lower values from such sales than if the debtor had more time to solicit bids or prospective purchasers had more time to conduct due diligence.

    - ***Proposal:*** Set a minimum amount of time prior to which a hearing on the sale of substantially all of the debtor's assets cannot be set in a Financing Order (*e.g.*, 180 days after petition date) (the "***Sale Threshold***"). In addition, to foreclose the possibility that a lender will attempt to circumvent the Sale Threshold by setting a quick maturity date, (i) establish a minimum maturity date for DIP loans that mirrors the Sale Threshold, and (ii) provide that DIP loans cannot mature or accelerate simply on account of the sale not closing within 60 days after the order approving the sale. Establishment of these thresholds should not disadvantage lenders because they will still have the ability to set financial and performance driven covenants designed to protect the lender from a deterioration in collateral coverage. They will also still be able to seek to lift the automatic stay to pursue state law remedies. In the event that a melting ice cube or emergency situation necessitates a 363 Sale of substantially all of the debtor's assets, the debtor would retain the ability to seek a 363 Sale hearing before the Sale Threshold, with approval of the sale subject to certain standards discussed in *Issue #2 (Appropriate Timing for a 363 Sale) of Section I (Section 363 Sales). See* n.1. A Financing Order itself, however, may not set a 363 Sale hearing before the Sale Threshold; *provided, however*, that in the event the debtor makes a motion to conduct a sale earlier than the Sale Threshold pursuant to the Irreparable Injury

Standard, the maturity date of the DIP loan may be modified to a date that is no earlier than 15 days after the closing of such sale. *Id*.

- ***Issue #2: Control of Chapter 11 Case Through Use of Milestones.*** Similarly, lenders increasingly try to control the speed and direction of chapter 11 cases through use of milestones in financing documents, such as deadlines for filing chapter 11 plans, confirming chapter 11 plans, and limits on debtors' exclusive periods to file and solicit acceptances of a chapter 11 plan. Failure to comply with these deadlines is usually an event of default under the documents.

    - ***Proposal:*** Prohibit Financing Orders from limiting any of the statutory rights granted to debtors by the Bankruptcy Code, such as the exclusive periods to file and solicit acceptances of a plan. Lenders may object to the proposed extension of exclusive periods or request milestones as a condition to granting any such extension. Courts already condition extensions of exclusive periods in certain cases on achievement of various milestones. Financial covenants would continue to protect DIP lenders from changes in the debtor's ability to satisfy its obligations under the DIP financing agreement.

- ***Issue #3: Roll-Up Provisions.*** Increasingly, DIP lenders require that debtors use DIP financing to "roll-up" their prepetition secured debt to postpetition status, often at higher interest rates and while providing little new financing (*e.g.*, *Circuit City*). The effect of a roll-up is to require a debtor to satisfy the rolled-up debt as an administrative claim under the chapter 11 plan, rather than as a secured claim that can be crammed down. This is especially problematic where the DIP lenders are a group consisting of multiple lenders. Absent a negotiated alternative in the Financing Order, the lenders may take a position that as an administrative claim, 100% lender consent would be required to agree to accept anything other than full cash payment of such claim under a plan. By requiring their prepetition debt to be rolled-up, DIP lenders thus exercise control over the chapter 11 process and limit the debtor's reorganization options.

    - ***Proposal:*** Prohibit all roll-ups, except to the extent (i) the collateral constitutes receivables and/or inventory, (ii) the rolled-up debt provides incremental liquidity to the debtor and is in the best interests of the debtor's estate, and (iii) the amount of the rolled-up debt is limited to the value of the prepetition collateral collected. Such rolled-up debt should be classified in a separate administrative claim class, be subject to the acceptance requirements of section 1126(c) (so that only 2/3 in amount and 1/2 in number of the voting lenders are needed to accept the plan), and be payable in cash or other consideration, but not be subject to potential cramdown under section 1129(b) of the Bankruptcy Code.

- ***Issue #4: Cross-Collateralization.*** Forward cross-collateralization enables a lender to secure prepetition debt with postpetition collateral. A lender is thereby able to improve its prepetition position in chapter 11, to the detriment of other creditors.

    - ***Proposal:*** Prohibit forward cross-collateralization other than for use as adequate protection, *i.e.*, to the extent of diminution in the lender's interest in the collateral.

- ***Issue #5: Lack of Competition for DIP Financing.*** There is very limited competition for DIP financing for a variety of reasons, including difficulty priming prepetition secured lenders. In addition, once initial DIP financing is obtained, usually through the prepetition secured lenders, there is difficulty in obtaining take-out DIP financing because (i) the "rolled-up" debt necessitates a new DIP lender to take out the "rolled-up" debt as well as the new funds that are advanced, thereby increasing the amount of funds necessary to accomplish a take-out of an existing DIP lender, and (ii) prepayment penalties in DIP financing agreements would also have to be paid. Greater competition for DIP financing will help lower the cost of postpetition financing for debtors and help reduce the abuses discussed herein that have become common with postpetition financing.

    - ***Proposal:*** To enhance the prospects for take-out DIPs, the following should apply: (i) prohibit approval of roll-up provisions except under the conditions set forth above (*see Issue #3 (Roll-Up Provisions)*), (ii) limit interim DIP financing approval to funds necessary to operate the debtor during the interim period, (iii) prohibit prepayment or similar penalties in DIP financing agreements during the interim period, and (iv) require that DIP loans or adequate protection provisions not unduly restrict a debtor's ability to refinance a DIP loan, including, without limitation, not precluding the debtor from incurring reasonable expenses to encourage competitive DIP bidding.

- ***Issue #6: Liens/Claims on Causes of Action.*** DIP lenders typically request liens on chapter 5 causes of action and superpriority claims payable from proceeds of such actions. DIP lenders also request liens on collateral that is freed as a result of lien avoidance actions pursuant to section 724. Because these causes of action are thought by courts, trustees and creditors' committees to be an important source of recovery for unsecured creditors, courts disfavor granting liens to DIP lenders on these causes of action. DIP lenders argue, however, that because proceeds of chapter 5 causes of action and the collateral that is freed by section 724 causes of action are property of the estate, in the event there is insufficient cash to repay a DIP loan, proceeds from such causes of action should be used to pay off the DIP loan.

    - ***Proposal:*** Prohibit Financing Orders from granting DIP lenders liens and superpriority claims on chapter 5 (other than claims under section 549 of the Bankruptcy Code, unless the DIP lender is complicit in the transfer) and section 724 causes of action, including proceeds thereof.

- ***Issue #7: Control of Management.*** It has become increasingly common for lenders to condition postpetition financing on appointment of a chief restructuring officer ("***CRO***") who must be acceptable to the lender. This power to select/appoint management is a deviation from corporate governance outside of chapter 11, where lenders do not select/appoint management, and may impair management's ability to operate the chapter 11 case for the benefit of all stakeholders, not just the senior lender. (For example, in *Pilgrim's Pride*, the debtor covenanted that it will at all times while the DIP loan is outstanding have a CRO who is reasonably acceptable to the lender and whose scope and

authority are reasonably acceptable to the lender. Failure to comply with such covenant constituted an event of default. In *LandSource Communities Development*, the DIP financing agreement provided that the CRO would be appointed to a one-member executive committee of the company if one of the borrowers requested an extension of the plan exclusivity periods without the agent's consent and without meeting certain requirements.). The selection of a CRO, if any, is typically something that is resolved before the DIP financing motion is filed, with the CRO selection being made by the debtor frequently with the lenders' nod. Although changes to financing rules may not change this practice, imposing certain limits on Financing Orders may help curb the more aggressive lender controls over management appointments.

- ***Proposal:***[5] Prohibit Financing Orders and related agreements from containing (i) provisions requiring the appointment of management or a CRO if a debtor does not meet certain deadlines that by statute or court order it may have a longer time to meet, such as the exclusive period to file and solicit acceptances of a plan, or (ii) provisions dictating the authority or scope of a CRO's duties or requiring lender consent to same; *provided, however*, that Financing Orders may condition the financing upon a CRO being selected by the debtor that is reasonably acceptable to the DIP lender. All creditors may already be heard on a motion to approve the engagement of a CRO, which includes the scope of authority.

- ***Issue #8: Impairment of Unsecured Creditor Rights***. As a condition to postpetition financing, lenders often require debtors/estates to waive (i) rights under sections 506(c) and 552(b) of the Bankruptcy Code and (ii) the ability to seek non-consensual use of cash collateral later in the chapter 11 case. In addition, lenders typically request that the court make findings (or the debtor stipulate) in the Financing Orders that their prepetition liens are valid. Debtors should not be asked to waive rights granted to them by the Bankruptcy Code (such as rights under sections 506(c) and 552(b) and the right to seek non-consensual use of cash collateral) just to obtain postpetition financing, and courts are usually hesitant to do so. With respect to findings that the lenders' prepetition liens are valid, although it may be reasonable for debtors to agree to these provisions to obtain postpetition financing, such provisions are usually prejudicial to unsecured creditors, who are not involved in negotiating the initial postpetition financing agreements and have not had the opportunity to investigate the liens. As a result, it has become customary for the creditors' committee, once formed, to negotiate with DIP lenders to try to obtain carve-outs from these provisions.

  - ***Proposal:***

    - Prohibit waivers of section 506(c);

    - Prohibit waivers in interim Financing Orders of the right to seek non-consensual use of cash collateral;

[5] This proposal may need to be reconsidered in light of the proposals to be finalized on governance.

- Prohibit waivers in interim and final cash collateral orders of the right to seek non-consensual use of cash collateral after expiration, pursuant to the terms of such cash collateral orders, of the use of cash collateral;

- Amend Rule 4001(b)(2) and (c)(2) to provide that final hearings on the use of cash collateral or DIP financing may not be held earlier than 30 days after entry of the interim Financing Order; *provided, however*, that upon request of the debtor, the court may conduct a final hearing before such time period (but in no event earlier than 14 days after entry of the interim Financing Order) if the creditors' committee[6] has consented; and

- Prohibit waivers of section 552(b) rights.

- The creditors' committee[7] may investigate whether the lenders' prepetition liens are valid. Allow the use of postpetition financing for such investigation, within limits set forth in Financing Orders based on the circumstances of the case. Codify factors or establish guidelines that should be relevant in determining whether circumstances of the case justify the applicable limits set forth in the Financing Orders, including, without limitation, (i) whether the case needs to be confirmed quickly, (ii) whether general unsecured creditors will benefit from an investigation of prepetition secured lenders' liens, and (iii) whether the debtor has already conducted an investigation into the liens (consider requiring the debtor to share the results of the investigation with the creditors' committee). *See also Issue #3 (Payment for the Bankruptcy Process in the 363 Sale Context) of Section I (Section 363 Sales).*

[6] This proposal may need to be reconsidered in light of the proposals to be finalized on creditors' committees.

[7] *See* n.6.