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American Bankruptcy Institute Commission to Study the Reform of Chapter 11: A Review of Significant Recommendations for Large Chapter 11 Cases

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I. Introduction

Since the 19th century, there has been a pattern of overhauls of the corporate reorganization provisions of the federal bankruptcy law approximately every 40 years. There were major enactments in 1898, 1938 and in 1978—the last of these being the enactment of the current Bankruptcy Code. The 40th anniversary of the enactment of the Bankruptcy Code will occur in 2018, and some have suggested that it is again time to reboot our corporate insolvency system. While the current version of chapter 11 is much admired and is increasingly emulated in other countries, it is certainly true that financial markets, capital structures and participants have evolved significantly since 1978, and in some respects these changes have outgrown our current statutory framework.

Corporate balance sheets, in particular, have changed dramatically over the past few decades, with enormous growth in the absolute amount and variations of corporate indebtedness and the amount and types of debt secured by all or substantially all of debtors' assets. Other shifts in the commercial landscape have included the increased complexity and globalization of corporate groups, the increased frequency of "mega-cases," the development of the whole-company M&A market and its extension to distressed firms, sales of substantially all of debtors' assets outside of a plan (especially during the earliest days of chapter 11 cases), the increased prevalence of off-balance sheet "legacy" liabilities (e.g., retiree medical and pension claims), mass tort liabilities and environmental liabilities, the birth and explosive growth of distressed debt trading, the evolution away from traditional buy-and-hold lenders to more sophisticated and nimble investors, the invention of derivatives and other new complex credit products and the increased prevalence of disputes and litigation in bankruptcy cases, including litigation over claims priorities, lien perfection, fraudulent transfers and collective bargaining agreements. Special interest amendments have also been added to the Bankruptcy Code over time, eroding the concept of equality of treatment upon which the original Bankruptcy Code was based.

Sophisticated parties have exploited opportunities created by the statute, and courts have interpreted the Bankruptcy Code in unprecedented ways, including in connection with the scope of liens, section 363 sales, credit bidding, the plan voting process and in the context of cramdown.

These developments and others prompted the American Bankruptcy Institute, in 2011, to organize a Commission to Study the Reform of Chapter 11 (the "**Commission**"), designed to emulate commissions appointed by Congress in 1970 and 1994. Since that time, the 23-member Commission, together with approximately 140 practitioners, academics and judges appointed to topic-related advisory committees, studied and held hearings regarding a plethora of chapter 11 issues, large and small. The hearings included testimony from more than 90 witnesses. The Commission also organized a symposium that included leading legal scholars at the University of Illinois Law School who presented papers regarding rights and treatment of secured creditors in bankruptcy. On December 8, 2014, the Commission released a nearly 400-page report, setting forth its recommendations for reform of chapter 11 of the Bankruptcy Code (the "**Report**").

This memorandum provides an overview of 10 broad categories of Commission recommendations that we believe are of significance to lenders and investors in large chapter 11 cases. It also notes, where relevant, certain possible reforms that were raised by commentators and witnesses but that the

Commission did not propose. The Report also proposes reforms specifically applicable solely to small and medium-sized bankruptcy cases, which are not covered in this paper.[1]

Where the Commission's recommendations go from here is not yet clear. Some of its recommendations almost certainly will be considered by Congress, and debate will no doubt ensue. However, whether or not the Commission's recommendations are ultimately adopted into law, the Report is well-documented and represents significant input from the bankruptcy community, and as such it is highly likely to heavily influence the thinking of practitioners, judges, lenders and investors in chapter 11 cases going forward.

II. Ten Significant Categories of Recommendations Affecting Lenders and Investors

Much of the Report is focused on the role and impact that secured creditors have in large chapter 11 cases. Among other things, the Report seeks to clarify lenders' rights in chapter 11 cases and:

> "…[i]ncorporate checks and balances on the rights and remedies of the debtor and creditors, including through valuation concepts that potentially enhance a debtor's liquidity during the case, permit secured creditors to realize the reorganization value of their collateral at the end of a case, and provide value allocation to junior creditors when supported by the reorganization value."[2]

As can be seen from the quotation above, while some of the Commission's recommendations would be beneficial to secured creditors, many would constrain secured creditors' rights compared to current law. Among other things, the Report is keenly focused on the ability of debtors to finance themselves during a chapter 11 case and avoiding forced sales in the context of blanket liens securing debts exceeding the going concern value of the debtor on the petition date. Many of the Report's recommendations strike a balance between secured creditors' rights outside of bankruptcy (to foreclose on collateral piecemeal) and the ability of the secured creditor to benefit from preservation of the firm's going concern value through a sale under section 363 or a reorganization under a chapter 11 plan. This crucial (re)balancing of creditors' rights is likely to be the most controversial aspect of the Report and is the focal point of the discussion of the Commission's key recommendations below.

A. Rights of Pre-Petition Secured Creditors

The Report's recommendations would alter the rights of pre-petition secured creditors in a variety of ways. Specifically, the Report:

- Proposes new rules for valuing secured creditors' collateral at different times and for different purposes during the bankruptcy process, including:

[1] The Commission recommended the creation of a new term, "small or medium-sized enterprise" (SME), which means a business debtor with (i) no publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's case; and (ii) less than $10 million in assets or liabilities on a consolidated basis with any debtor or non-debtor affiliates as of the petition date. A series of proposed reforms in the Report would apply specifically to SME cases.

[2] AM. BANKR. INST. COMM'N TO STUDY REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS 6 (2014).

  - Using foreclosure value as the benchmark for adequate protection; and
  - Allowing secured creditors to receive the going concern value of their collateral in connection with a reorganization of the firm or a going concern sale of substantially all of the debtor's assets;
- Recommends against a fixed percentage surcharge against collateral for the benefit of junior creditors;
- Affords an "out of the money" junior class of creditors the right to insist on receiving distributions reflecting the possibility that the junior class might have been "in the money" had the valuation of the firm (either through sale or in connection with a reorganization) occurred at a future date;
- Clarifies the method for calculating cramdown interest rates in the event that a plan provides pre-petition secured creditors with "takeback paper," or debt in the reorganized company, rather than repayment in cash; and
- Recommends a handful of reforms that would limit certain traditional secured creditor negotiating tools, including sections 506(c) and 552(b) waivers and "gifting."

1. Balancing of Secured Creditors' Rights

The Report recommends several clarifications in the way that secured creditors' collateral is valued and applied for purposes of chapter 11 proceedings. Taken together, the recommendations seek to form a coherent and analytically consistent set of rights and remedies for secured creditors throughout a chapter 11 case—essentially, a "grand bargain."

(i) Valuation of Secured Creditors' Collateral

The Report strikes a balance between the pre-petition bargain of a secured creditor and a debtor's ability to obtain post-petition financing to reorganize the firm. The Report notes that it is unclear whether a secured creditor's "bargain" includes the right to the "going concern surplus" generated by reorganizing the firm in chapter 11 rather than liquidating it under state law. If the debtor were unable to provide adequate protection, the secured creditor would be entitled to have the automatic stay lifted. If the stay were lifted, however, the secured creditor could do nothing more than pursue its right to a state law foreclosure sale of its collateral. For this reason, the Report takes the view that the foreclosure value of the secured creditor's collateral, rather than its going concern value, should be used for determining whether adequate protection has been provided. On the other hand, the Report recommends affording the secured creditor the full going concern (reorganization) value of its collateral in connection with final distributions in the case.[3] This compromise allows the debtor greater flexibility to finance itself during the early stages of the case, but protects the secured creditor's ultimate right to reap the benefits of the reorganization at the end of the case. According to the Report, this bifurcated approach is consistent with existing section 506(a), which states that value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of [the] property."

[3] The right to going concern value in connection with ultimate distributions in the case is subject to the entitlement of junior classes to any Redemption Option Value, as more fully discussed below.

Adequate Protection

The filing of a chapter 11 petition stays the enforcement of creditors' non-bankruptcy law rights against a debtor, including any efforts by secured creditors to foreclose on collateral. Under certain conditions, a debtor may also use property of the estate, including a secured creditor's collateral, to operate its business and facilitate reorganization. Section 361 of the Bankruptcy Code guarantees secured creditors "adequate protection" of their interests in property of the estate. Adequate protection has generally been interpreted to mean compensation for any depreciation or diminution in the value of secured creditors' interests caused by the debtor's use of the collateral during the bankruptcy case. Courts currently use several different valuation standards to determine secured creditors' rights to adequate protection, ranging from liquidation value to going concern value of the collateral, depending on the facts of the case and the persuasiveness of the parties.

The Report proposes that secured creditors should be entitled to receive adequate protection equal to the *foreclosure value* of their collateral. Foreclosure value would be measured by the net value that secured creditors would realize upon a hypothetical, commercially reasonable foreclosure sale of their collateral. The Report also proposes that the foreclosure value standard should apply to an adequate protection motion related to post-petition lenders priming pre-petition secured creditors' interests.

The Commission also considered the form in which debtors should be permitted to offer adequate protection to secured creditors. The Report recommends that debtors should be permitted to use cross-collateralization to provide adequate protection; however, debtors should not be permitted to grant liens on chapter 5 avoidance actions or their proceeds.

It is important to reflect here on the compromise struck by the Commission in its approach to adequate protection as part of its broader effort to balance the rights of secured creditors with the reorganizational objectives of the estate. The Report recommends that if a sufficient "value differential" exists between foreclosure value and what could be realized in connection with a section 363 sale of the collateral, such value differential can be determined by the court to constitute adequate protection of the secured creditor, without more. In other words, the court could determine that the secured creditor's "equity cushion" in the collateral, if large enough, constitutes adequate protection under section 361. Importantly, as discussed in further detail below, the Report recommends that a secured creditor should be entitled to receive going concern value of its collateral for purposes of ultimate distributions in the case after a section 363 sale of all or substantially all of the debtor's assets (referred to in the Report as a "**section 363x sale**"). Under the Report's recommendations, therefore, even though the secured creditor would have less leverage to force an early section 363 sale when there is a "value differential," if the trustee (or debtor in possession) were to sell the collateral in a section 363 sale, the secured creditor would be entitled to a secured claim based the section 363 sale value of its collateral, and not its foreclosure value.[4]

Moreover, if the court orders that a "value differential" constitutes adequate protection of the secured creditor's interest in collateral, the Report recommends that the court's order also provide that, if the court determines at a subsequent hearing that the secured creditor has presented sufficient evidence to warrant relief from the automatic stay with respect to the collateral, the trustee will conduct a sale of the collateral under section 363, unless the secured creditor elects otherwise. Under this approach, while the secured creditor would trade some of its leverage to force an early section 363 sale, it would ultimately

[4] The Commission's proposed recommendations in connection with sales of all or substantially all of the debtor's assets are described in more detail in the section below, titled "Asset Sales." The right to section 363 sale value is subject to any entitlement of junior classes to Redemption Option Value, as more fully discussed below.

have the ability to effectuate a section 363 sale and retain the proceeds of such sale if the automatic stay were later lifted.

Valuation of Collateral for Chapter 11 Plan Purposes

A secured creditor receives a higher priority distribution under a plan only to the extent of its allowed secured claim, which is equal to the value of the creditor's interest in a debtor's property. As a result, the value of a secured creditor's collateral, and whether the secured creditor is entitled to the full going concern value of its collateral, is often a subject of dispute. As noted above, the Report includes a recommendation that, for chapter 11 plan purposes, secured creditors' secured claims should be valued at the ***reorganization value*** of their collateral. Reorganization value would be measured based on a debtor's proposed method of exiting bankruptcy. For debtors that reorganize, the reorganization value would be the enterprise value attributable to the reorganized entity (or the portion thereof attributable to the secured creditor's collateral). For debtors that sell all or substantially all of their assets, the reorganization value would be the net sale price for the enterprise.

The reorganization value standard and the foreclosure value standard, discussed above with respect to adequate protection, are bookends of the delicate balance struck in the Report. The reorganization value standard protects secured creditors' ultimate rights to the going concern value of their collateral and compensates them for their contribution to the reorganization—the debtor's use of their collateral as the debtor works toward a successful restructuring. At the same time, the foreclosure value standard protects debtors' and other stakeholders' interests in having breathing space and time to reorganize by helping debtors obtain much-needed liquidity early in their cases, which gives them a chance to maximize the value of unencumbered assets for the benefit of unsecured creditors.

The reorganization value standard for plan purposes would likely provide benefits to secured creditors and the estate. A secured creditor's risk of having its claims valued at the liquidation value of its collateral would be eliminated, and all stakeholders would likely benefit from less litigation over the appropriate valuation standard. On the other hand, clarification of the valuation standard may also limit the range of possible compromises that debtors and secured creditors would be willing to make to achieve a consensual reorganization plan.

(ii) No Mandatory Surcharge on Secured Creditors' Collateral

Section 506(c) permits debtors to recover the costs and expenses of maintaining secured creditors' collateral from secured creditors. Although many commentators advocated for an amendment to this section to impose a mandatory surcharge on collateral for the benefit of pre-petition unsecured creditors in connection with section 363x sales, the Commission chose not to recommend one.

Commentators who supported imposing a mandatory surcharge argued that secured creditors with blanket liens on a debtor's assets receive more value from a court-supervised chapter 11 reorganization than they would from a foreclosure and piecemeal sale of the debtor's assets. As a result of the subsidy, the commentators argued, secured creditors should be forced to disgorge some of their recovery in favor of the rest of the estate, including unsecured creditors.[5]

[5] *See* Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862, 922–23 (2013); Barry E. Adler, Presentation at the ABI Illinois Symposium on Chapter 11 Reform 2014: Priority in Going-Concern Surplus (March 24, 2014) *available at* http://materials.abi.org/sites/default/files/2014/Mar/PriorityGoingConcernSurplus.pdf.

Although the Commission did not adopt this view, it did believe that the court should retain discretion to allocate the value of the estate to certain costs and expenses under section 506(c), and with respect to value generated after the petition date under section 552, which is discussed in further detail below.

(iii) Redemption Option Value

The absolute priority rule has long been one of the inviolable principles of bankruptcy law.[6] But the rigidity of the rule, according to the Report, can limit the possibility for consensual plans under certain circumstances and cause the value of the estate to be distributed in an arbitrary or unfair manner, particularly when valuation date of the firm for distribution purposes—whether the date of a section 363x sale or the effective date of a plan of reorganization—occurs during a downturn in the economic cycle or the business cycle of a particular company or industry.

To address these concerns, the Commission proposed a new distribution allocation entitlement, called the "Redemption Option Value," which would apply to a junior class of creditors that would otherwise receive little or none of the residual value of the firm under a plan of reorganization or after a section 363x sale. Under the Redemption Option Value proposal, the class of creditors immediately junior to the class that would otherwise receive the residual value of the reorganized firm would be entitled to receive *the value of a hypothetical option* to purchase the entire firm at a future date at a strike price equal to the senior class' or classes' full entitlement.[7] The value, if any, to be given to the junior class would be in the form of cash, debt, stock, warrants or other consideration (not necessarily a real option) and would be determined as of the valuation date based on a hypothetical option with an exercise period that expires three years after the debtor's petition date. The strike price of the option would be measured as the full amount owing to the senior class, including any unsecured deficiency, non-default contract rate and unpaid fees and expenses, as accrued through the exercise date of the option.

A court would be able to confirm a plan (or approve a section 363x sale) that does not strictly observe the absolute priority rule over the objection of an impaired senior class only if the deviation from the absolute priority rule were limited to the distribution to the junior class of the Redemption Option Value. Similarly, a court would be able to cram down a plan rejected by a junior class (or approve a section 363x sale where the junior class has not objected to the sale) only if the junior class receives at least the Redemption Option Value attributable to the plan or sale, if any, and, in the case of a plan, if the court determines that the reorganization value in the plan was not proposed in bad faith.

In some respects, the Redemption Option Value recommendation represents a significant departure from current law, namely, the absolute priority rule embodied in section 1129(b). On the other hand, it arguably reflects the way in which disputes over plan valuation and cramdown are settled in the shadow of the absolute priority rule. By reducing the range of possible disputes, it could save costs and reduce delays in chapter 11 cases. While the Report indicates that the Commission recognized the importance of the absolute priority rule as a means of protecting creditors, it also recognized that the rigidity of the rule can prevent successful reorganizations and cause value to be distributed to creditors unfairly depending on the timing of plan confirmation or section 363x sale. The Report, in effect, takes the position that the selection of a valuation recognition date for the firm is likely to be arbitrary. The fortuity

[6] *See N. Pac. Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

[7] For ease of discussion in this section, "junior class" refers to the class or classes of creditors junior to the class or classes that would otherwise receive the residual value of the reorganized firm, and "senior class" refers to the class or classes that would receive the residual value of the reorganized firm. Often, the senior class would be the fulcrum class of creditors, but not always.

of the valuation date may allow senior classes to be the exclusive beneficiaries of the continuation of the business as a going concern, while cutting off the possibility that valuing the firm at a later date might have permitted senior classes to be paid in full and junior classes to be paid some residual value.

In deciding to deviate from the absolute priority rule, the Report notes that the Commission identified two trends that, in its opinion, exacerbate the problem of unfair distribution at the time of plan confirmation or sale. First, the Commission recognized a trend toward greater control of the bankruptcy process by secured creditors, causing less flexibility during the negotiation process. Second, the average amount of time that debtors remain in chapter 11 is decreasing generally. In 2013, debtors exited chapter 11 proceedings in an average of less than 200 days, while in 1989, the average was close to 1,000 days. To the extent that bankruptcies are caused by economic cycles, industry events or trends, operational issues and other problems of a cyclical nature, a chapter 11 process of less than 200 days likely does not afford enough time for abnormally depressed valuations to normalize. As a result, at the time of plan confirmation or sale, the firm may be systematically undervalued, and the junior creditor class may be systematically undercompensated. By looking forward three years after the petition date, the junior class would benefit from a market valuation that better accounts for the potential future value of the firm, rather than one that merely represents an arbitrary point in time (the company's bankruptcy exit date).

The Report emphasizes that the Redemption Option Value should *not* result in a substantial loss of value for the senior class because the senior class would benefit from the upside potential of its equity interest in the firm. Where the debtor reorganizes under a plan rather than a section 363x sale, the junior creditor class or classes would only get the Redemption Option Value if the senior class or classes received the preponderance of the residual value of the reorganized firm.[8]

When value is distributed after a section 363x sale to a third party, however, the Report's recommendation may result in a reduction in distributions to the senior class without the possibility of compensation through the retention of any upside. If the entire firm is sold to a third party for consideration other than equity, the senior class would retain no potential future upside to counterbalance the Redemption Option Value provided to the junior class. Although the Commission considered this issue, it nevertheless chose to apply the Redemption Option Value to section 363x sales out of a concern that not doing so would promote gamesmanship and encourage sales that would avoid violating the new proposed rule and effectively transfer future value to the senior class. Moreover, the secured creditor has the ability to retain the upside of the firm if it wants to do so by submitting a credit bid in connection with the section 363x sale.

As an additional protection for the secured creditor, the Commission's recommendation provides that the junior class would be entitled to the Redemption Option Value after a section 363x sale *only* if it does not object to the sale.

How substantial an effect the Redemption Option Value would have on distributions to senior classes will depend on the value of the senior classes' claims, the reorganization value of the firm and the length of the redemption period. If a senior class is deeply impaired, there is only a very small likelihood that the junior class would receive any Redemption Option Value. Similarly, a junior class would be less likely to receive a distribution if the length of proceedings is longer and hence the valuation date is closer to (or subsequent to) the mandated expiration date of the hypothetical option.

[8] The Report states that the Commission recognized that the issues of how the Redemption Option Value would be applied when the residual interests in the firm are allocated among several senior classes, and when the senior class or classes do not receive the entire residual value of the firm, require further development.

It is important to note that the Commission acknowledged the significant deviation from current practice that this proposal represents. While the Report outlines the broad contours of the Redemption Option Value proposal, the Commission recognized that its recommendations must be further developed in many respects to make them operational and effective in more complex chapter 11 cases.[9]

2. Cramdown Interest Rates

Under the cramdown provision of section 1129(b), a plan that provides for deferred payment of secured creditors may be confirmed over a secured creditor's objection if the plan provides that creditor with deferred cash payments that have a present value equal to the allowed amount of its secured claim. Though the provision appears simple, the discount rate used to calculate the present value of those deferred payments—so-called "takeback paper"—has been a matter of great controversy, especially recently, with courts using any of four different methods to calculate the discount rate. The Commission proposed a clarification of the appropriate valuation methodology.

Over the past several years, the pendulum has swung away from secured creditors with regard to cramdown interest rates. In 2004, in *Till v. SCS Credit Corporation*, the Supreme Court mandated the use of the "formula" approach to determine the discount rate in chapter 13 individual debtor cases. The formula approach uses the risk-free rate of return, increased by 100 to 300 basis points, and the Supreme Court chose it, in part, due to the ease of using the methodology.[10] In *Momentive*, a recent Southern District of New York bankruptcy case, the court applied the holding of *Till* to a chapter 11 case.[11] The secured creditors had argued that the court should use a market rate of interest, as suggested by a footnote in *Till*,[12] and that the use of the prime rate under-compensated them, especially in comparison to identical-priority exit facilities that the debtor had negotiated. The court nevertheless concluded that the market rate was not appropriate because secured creditors receiving takeback notes in cramdown circumstances were not entitled to be compensated for their "transaction costs and overall profits."

With its proposal, it appears that the Report attempts to swing the pendulum back after *Momentive*. The Report recommends expressly disallowing the use of the formula approach in chapter 11 cases. The Report also expressly recommends the use of a market rate of interest, as proposed by the creditors in *Momentive*, to determine the interest rate of secured creditor takeback paper. Where a market rate is not available, the Report recommends using a risk-adjusted rate that reflects the actual risk posed by the extension of credit to the debtor.

Had the Report's proposed rule been in place before the court's ruling in *Momentive*, the court's decision would likely have been an easy one. The secured creditors would have been entitled to a market rate of interest, and the court would likely have accepted their argument to use the market rate determined by

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[9] For a list of the areas in which the Commission believes this proposal must be further developed, *see* AM. BANKR. INST. COMM'N TO STUDY REFORM OF CHAPTER 11, FINAL REPORT AND RECOMMENDATIONS at pages 231–235 (2014).

[10] *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) ("[T]he formula approach entails a straightforward, familiar and objective inquiry, and minimizes the need for potentially costly additional evidentiary hearings.").

[11] *In re MPM Silicones, LLC*, No. 14-22503, 2014 WL 4436335, at *1–*34 (Bankr. S.D.N.Y. Sept. 9, 2014).

[12] The plurality in *Till* noted that a market test may be more appropriate for determining the discount rate in a chapter 11 case. In a footnote, it stated that because, in chapter 13, "every cramdown loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cramdown lenders. Interestingly, the same is *not* true in the Chapter 11 context . . . . Thus, when picking a cramdown rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Till*, 541 U.S. at n.14.

reference to the debtor's in-place exit facilities. Rather than receive an interest rate of around 4%, the secured creditors could have received an interest rate closer to 6% or 7%.

3. Limits on Sections 506(c) and 552(b) Waivers

Although the Report recommends, as discussed above, that secured creditors should be free from a mandatory surcharge in connection with collateral sales, the Report also recommends that debtors should not be permitted to waive their rights under sections 506(c) and 552(b). Under section 506(c), debtors are permitted to recover, from secured creditors' collateral, the necessary costs and expenses of preserving or disposing of that collateral. Under section 552(b), the extension of secured creditors' pre-petition liens on post-petition property may be limited based on the "equities of the case." Under current law, debtors often enter into agreements with secured creditors that waive their rights to pursue recoveries under sections 506(c) and 552(b) in order to secure post-petition financing facilities and/or cash collateral agreements or for other reasons. The Commission's view was that these waivers relinquish claims that are potentially valuable to the whole estate. Additionally, the waivers are often granted at a time when debtors have substantially less leverage than their secured creditors, such as during negotiations for DIP financing.

The Report recommends that, in light of these considerations, the court should be permitted to review section 506(c) and 552(b) claims based on the circumstances of each case, rather than allow the trustee to waive those rights from a weakened bargaining position.

4. Limits on Gifting

The Report also recommends disallowing class-skipping transfers that violate absolute priority. When junior creditors have colorable claims in respect of the property of the estate, often litigation-related, such claims are often settled by "gifts" from senior, "in the money" creditors to prevent the junior creditors from asserting their claims and holding up plan confirmation. The Commission considered the efficiencies associated with class-skipping transfers—or "gifting"—including the ability to resolve objections to plan confirmation. But the Commission felt that these transfers often occur at the expense of creditor priorities and checks on self-interested behavior and undue influence by creditors. Arguably, the recommendation would limit the hold-up value of junior creditors' claims on the estate, and perhaps encourage junior creditors to drop their claims rather than threaten litigation. However, some creditors may take a "scorched earth" approach to litigating their claims anyway.

B. Debtor-in-Possession Financing

The Commission's recommendations regarding post-petition financing ("**DIP Financing**"), if implemented, would likely shift the balance of power at least slightly in favor of chapter 11 debtors, rebalancing a perceived drift of leverage in the direction of secured creditors since the enactment of the Bankruptcy Code, particularly in recent years. The Commission identified four trends, discussed below, which have substantially increased the ability of pre-petition secured lenders to control both the DIP financing process and, through it, the course of chapter 11 cases. Although the Commission recognized that the status quo has produced deep and liquid markets for post-petition financing, it appears to believe that the cost has been a significant reduction in flexibility for debtors and other stakeholders, which the Report seeks to reduce through its recommendations.

1. Intercreditor Agreements

Intercreditor agreements between junior and senior secured creditor groups often contain clauses that prohibit the junior secured creditors from offering DIP Financing without the consent of the senior secured creditors. These types of clauses reduce the pool of available post-petition creditors, sometimes significantly, and tend to affect precisely those creditors that would be most familiar with the debtor and willing to extend post-petition credit. Even where DIP Financing from an outside creditor is still available, it is reasonable to assume that the reduction in competition for the credit allows creditors to achieve higher returns and more favorable non-economic terms, with corresponding costs to the bankruptcy estate. Against this, the Report indicates that the Commission balanced the general policy in favor of respecting private contracts.

The Report therefore recommends that junior secured creditors subject to this type of a restriction be permitted to offer competing DIP Financing subject to two important conditions: (i) no such facility will be permitted to prime the senior secured creditors' pre-petition liens absent their consent; and (ii) if the court approves such a facility, the senior secured creditors will have the right to provide DIP Financing on the same terms in lieu of the junior creditors. Provided that these two safeguards are included to protect the legitimate interests of senior secured creditors, the Report further recommends that the Bankruptcy Code be amended to bar suits for breach of the intercreditor agreement by senior secured creditors against any junior secured creditors that offer competing financing.

2. Restrictions on Extraordinary Financing Provisions in Interim Orders

The Commission identified certain "extraordinary financing provisions" that the Report recommends be curtailed in some respects, but not eliminated. Specifically, the Commission appeared concerned that the process, typical of large chapter 11 cases, of splitting approval of DIP Financing into "interim" orders and "final" orders has, to some degree, undermined the ability of debtors and other stakeholders to review, consider and challenge certain conditions now often found in both the documentation and enabling orders for DIP Financing. Interim orders approving entry into post-petition financing, like many other important orders, are typically approved very shortly after the commencement of a case; often, they are approved at the "first day" hearing. These interim orders are subject to modification by a final order, entered after the required notice. However, final orders rarely vary significantly from interim orders, and there can be costs to fighting the status quo.

The Report defines "extraordinary financing provisions" to include: (i) milestones, benchmarks and other provisions that require debtors in possession to perform certain tasks or satisfy certain conditions (discussed in greater length below); (ii) concessions regarding the validity or extent of lenders' pre-petition liens; (iii) "roll-up" provisions, by which pre-petition debt is refinanced through post-petition facilities; (iv) waiver of debtors' rights to surcharge lender collateral pursuant to section 506(c); and (v) waiver of debtors' rights to challenge the attachment of lenders' liens to proceeds of lenders' collateral under section 552(b)'s "equities of the case" exception. These provisions (and perhaps similar provisions) would no longer be included in interim orders approving post-petition financing.

3. 60-Day Moratorium on Milestones for Material Acts

In addition to the restrictions discussed above, the Report indicates that an additional protection is necessary to limit short-term milestones in DIP Financing packages, which have been found to be highly effective at guiding the outcome of bankruptcy cases. The Commission has recommended a 60-day moratorium, running from the date on which the chapter 11 petition is filed,[13] on milestones that are likely to materially affect the debtor's operations or conduct of the case. These include deadlines to conduct an auction, close a material sale or file a disclosure statement and chapter 11 plan. The parties would not be able to set these types of deadlines to take effect within the first 60 days following a petition date and, as noted above, would not be able to set such deadlines at all in interim DIP orders. Less material milestones, such as reporting requirements, customary loan covenants and compliance with a budget would still be permissible within the 60-day post-petition window, provided that they did not achieve the same effect as a prohibited milestone. Likewise, milestones for material acts guiding the case could still be set after the initial 60-day post-petition window.

4. Roll-Up Limitations

Like short-term milestones, provisions that "roll up" pre-petition debt held by pre-petition lenders into post-petition facilities, or that require a debtor to pay off its pre-petition debt with the proceeds of its post-petition facility, were identified for additional oversight. Under the Commission's proposed principles, roll-up provisions remain permissible provided that two criteria are satisfied: (i) the post-petition facility is either (a) provided by a new lender or (b) repays the pre-petition facility in cash, extends substantial new credit to the debtor and provides more financing on better terms than alternative facilities offered to the debtor; and (ii) the court finds that the proposed post-petition financing is in the best interests of the estate. Presumably, debtors will be required to establish a record upon which courts can make the foregoing fact-specific findings. Whether laying this foundation will require evidentiary hearings, testimony or other discovery is unclear. It seems likely that, if adopted, these new requirements would open the door to more substantial challenges over DIP orders, and potentially significant delays in the entry of final orders.

5. Chapter 5 Avoidance Action Proceeds

The Commission has recommended excluding the proceeds of chapter 5 avoidance actions from the types of property on which debtors may grant liens as part of DIP Financings. Such proceeds would continue to be available in the event of a shortfall in the lender's adequate protection liens under section 507(b), but they could no longer be offered as part of the collateral package to prospective post-petition lenders or pledged as adequate protection.

This recommendation, if adopted, would improve the prospects for unsecured creditors in cases where chapter 5 avoidance action proceeds prove to be a key source of recovery. However, the recommendation would also foreclose the strategy of pledging legally marginal avoidance actions to avoid their becoming an attractive nuisance in the case. The cost of increased motion practice and litigation of marginal claims, often against ongoing suppliers and customers, might significantly reduce the net benefit to general unsecured creditors and reduce recoveries overall.

[13] Or the date on which the order for relief is entered, whichever is later. In practice, these dates tend to be identical.

C. Asset Sales

One benefit of the U.S. bankruptcy system is the ability of a debtor in possession to continue its operations during the pendency of its bankruptcy case and to begin to effectuate its reorganization by selling property for the benefit of the estate. Section 363 and its many provisions, which govern a debtor's ability to use, sell or lease property outside the ordinary course of business, are typically used continually throughout the reorganization process, including to effectuate sales of all or substantially of a debtor's assets. The Commission recommended a number of changes to section 363 concerning a debtor's use, sale or lease of discrete assets. In addition, the Commission proposed an entirely new section to govern the sale of all or substantially all of a debtor's assets—a practice that has increasingly been used in recent years as an alternative exit strategy to a plan of reorganization.

1. Section 363 Non-Ordinary Course Sales

With respect to the use, sale or lease of discrete assets, the Commission has proposed a number of changes to current law. The proposals cover standard of review, sale of assets free and clear of interests, credit bidding and finality of sale orders.

(i) Standard of Review

Bankruptcy courts must approve non-ordinary course transactions proposed to be entered into by debtors. Courts use a business judgment standard to review these section 363 motions, which is a deferential review that focuses primarily on the decision-making process of debtors' boards of directors. The Commission recommended a slightly higher standard of review, known as the enhanced or intermediate business judgment standard, in which courts review not only the process implemented by the company but also the reasonableness of the board's business judgment under the circumstances. The recommendation, if adopted, would give the court a much more active role in determining the appropriateness of the decision to sell. It would create a greater evidentiary burden on requesting debtors and possibly add challenges, costs and time to litigate challenges to debtors' decision-making processes. However, it may or may not lead to significant changes in the way courts ultimately decide these issues.

(ii) Sales Free and Clear of Interests

Section 363(f) allows debtors, under certain circumstances, to sell assets free and clear of all interests in those assets. The provision facilitates sales and provides debtors with important liquidity and flexibility during restructurings. As with certain other provisions in the Bankruptcy Code, section 363(f) does not define the meaning of a key term—interests—and courts have interpreted the term to encompass different types of interests. The Report's recommendation would clarify that "interests" include litigation claims, discrimination claims and successor liability claims. The Commission appears to believe that this proposal will bring section 363(f) closer into line with the discharge injunction, which is particularly important where a debtor is selling all or substantially all of its assets. The Commission also recommended that assets should not be sold free and clear of certain other interests, such as land use restrictions, environmental liabilities that run with the land and successorship liability under federal labor law.

(iii) Credit Bidding

Under section 363(k), a secured creditor may bid up to the full amount of its allowed secured claim in any sale of its collateral pursuant to section 363(b). The Bankruptcy Code permits courts to limit this right for "cause," but "cause" is not defined. In *Fisker Automotive Holdings*, the court found cause to limit a secured creditor's right to credit bid, *inter alia*, in order to foster a more competitive auction process.[14] This ruling, and certain decisions following it, suggest that courts may be willing to limit credit bidding out of concern that it could chill an otherwise competitive bidding process. Since all credit bidding arguably chills competitive bidding, some have expressed concern that courts will be unable to formulate a coherent and consistent limiting principle, and important predictability with regard to credit bidding rights may be lost.

The Report's recommendation appears aimed at clarifying and confining the holding of *Fisker*. Under the Report's recommendation, a court may still limit credit bidding for cause, but any chilling effect of the credit bid itself cannot constitute cause.

(iv) Finality of Sale Orders

Different bankruptcy courts have applied different standards to motions to reconsider section 363 sales, and certain courts have permitted the reconsideration of a section 363 sale for the sole reason that the sale could have been completed at a higher price.[15] The Commission weighed the importance of commanding the highest sale price for a debtor's property against the competing importance of allowing a debtor to close a sale and move forward in its reorganization. To address these concerns, the Report recommends that a court should reconsider a non-ordinary course transaction only if it finds extraordinary circumstances or material procedural impediments to the sale process. Under the recommendation, the potential that a new or continued sale process would generate higher value for the estate alone would not constitute extraordinary circumstances.

2. Section 363x Sales of All or Substantially All Assets

The Commission has recommended two additional modifications in the context of sales of all or substantially all of the assets of debtors. Although such sales became common not too long after passage of the Bankruptcy Code, lingering uncertainty exists as to their propriety both as a statutory matter and a matter of policy.[16] Courts have been generally willing to permit sales of all or substantially all

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

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

[16] *Compare In re Braniff Airways, Inc.*, 700 F.2d 935, 940 (5th Cir. 1983) ("The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan *sub rosa* in connection with the sale of assets.") (italics original) *with In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) ("Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for."); *see also In re General Mot. Corp.*, 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009), *aff'd sub nom. Parker v. Motors Liquidation Co. (In re Mot. Liquidation Co.)*, (*cont.*)

assets, provided that sufficient justification is shown for the sales.[17] Factors examined in the traditional analysis include: (i) the proportionate value of the asset to the estate as a whole; (ii) the amount of time elapsed since the petition date; (iii) the likelihood that a plan of reorganization would be proposed and confirmed soon thereafter; (iv) the effect of the proposed sale on future plans of reorganization; (v) the proceeds to be obtained as compared to appraisals of the property; and (vi) whether the asset or assets are increasing or decreasing in value.[18] As with other sales outside the ordinary course of business, courts typically are acutely focused on the sale process, requiring that any process be thorough and designed to attract the highest possible offers, often by way of a public auction.

Despite the high level of care taken by most courts in supervising section 363x sales, some commentators have expressed concern that section 363x sales undermine important bankruptcy policy by circumventing the full disclosure and voting requirements applied to plans of reorganization.[19] Among other important considerations, section 363x sales can be conducted extremely quickly, and an empirical analysis by the Commission suggested a decline in the length of time between commencement of chapter 11 cases and sales of substantially all assets through a section 363x sale. The Report articulates the view that, although quick section 363x sales have significant benefits, they proceed more quickly than is necessary in many cases, potentially resulting in less robust auctions and commensurately lower recoveries. In a bankruptcy caused by an acute crisis in a debtor's industry, a quick section 363x sale may also result in a sale near the bottom of the market, resulting in a windfall to the purchaser (potentially a secured creditor making a credit bid) at the expense of other stakeholders. According to the Report, some members of the Commission expressed concern that debtors may not have sufficient time to explore stand-alone reorganization options and other alternatives. Lastly, the Report noted the concerns of courts and commentators that there may be a lack of sufficient disclosure in some section 363x sales, relative to the plan process, depriving parties in interest of sufficient information to assess the desirability of the proposed sale relative to a restructuring alternative.

As a consequence, the Report includes a recommendation that a new provision, mirroring some of the provisions of section 1129, be added to govern section 363x sales and incorporate into the sale process protections similar to those afforded to creditors in the chapter 11 plan process. Under the Commission's proposal, a section 363x sale would have to comply with all applicable principles of the Bankruptcy Code.[20] The proponent of a section 363x sale would likewise have to comply with the provisions of the Bankruptcy Code,[21] and the sale would have to have been proposed in good faith.[22] Payments made in connection with a sale, such as for costs and expenses, would have to either be approved or subject to approval by the court.[23] Unless the holder of a claim agreed to different treatment, the debtor would have to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of the kind specified in

(*cont.*)

430 B.R. 65 (S.D.N.Y. 2010) (noting continued validity of *sub rosa* doctrine, while noting that sales of all or substantially all assets remain permissible).

[17] *See In re Chrylser LLC*, 405 B.R. 84, 95-96 (Bankr. S.D.N.Y. 2009) (although a debtor may not enter into a transaction that would amount to a *sub rosa* plan, if "the transaction 'has a proper business justification' which has potential to lead toward confirmation of a plan and is not to evade the plan confirmation process, the transaction may be authorized.") (quoting *Motorola v. Comm. of Unsecured Creditors (In re Iridium Operating LLC)*, 478 F.3d 452, 467 (2d Cir. 2007)).

[18] *In re Chrysler*, 405 B.R. at 95 (citing *Lionel*, 722 F.2d at 1071).

[19] *See, e.g.*, 11 U.S.C. § 1129 (requirements for plan confirmation).

[20] *Cf.* 11 U.S.C. § 1129(a)(1) ("The plan complies with the applicable provisions of this title.").

[21] *Cf.* 11 U.S.C. § 1129(a)(2) (language similarly tracks proposal, as do the provisions cited below).

[22] *Cf.* 11 U.S.C. § 1129(a)(3).

[23] *Cf.* 11 U.S.C. § 1129(a)(4).

section 507(a)(2) or (3) through the closing of such sales.[24] All fees payable under section 1930 of title 28 would have to be paid or provided for at the closing of a sale.[25]

Debtors would also be required to provide adequate notice and an opportunity to be heard to all creditors and equity security holders that might be affected by a release or discharge that provides claims protections for the purchaser in the order approving the sale. Lastly, it is proposed that section 363x sales would have to be followed by either a confirmed plan under section 1129, a conversion under section 1112 or a "clean" dismissal. In other words, the Report recommends that "structured dismissals" be eliminated, as discussed further below.

(i) 60-Day Moratorium on Section 363x Sales

In addition to the protections described above, the Report recommends that section 363x sales should not generally be permitted in the first 60 days following the commencement of a chapter 11 case. As discussed below, this moratorium period synchronizes with other restrictions on major initiatives early in the case, most notably the proposed 60-day moratorium on significant milestones in DIP Financings.

However, recognizing that genuine urgency sometimes necessitates a rapid going concern sale, the recommendation includes an exception allowing courts to approve section 363x sales within the first 60 days of a chapter 11 case if: (i) the debtor or a party in interest demonstrates by clear and convincing evidence[26] that there is a high likelihood that the value of the debtor's assets will decrease significantly during the 60-day moratorium and (ii) the proposed section 363x sale satisfies the standards described in the prior section. This carve-out tracks the "melting ice cube" rationale sometimes invoked in expedited sales pursuant to section 363 under current law.[27]

D. Safe Harbors for Financial Contracts

The Report also recommends revisions to the Bankruptcy Code's safe harbors that permit non-debtor counterparties to close out and liquidate collateral for certain types of financial contracts without regard to the automatic stay or other limitations normally applicable to the exercise of default rights in executory contracts. Congress has long sought to balance the important policies underlying the bankruptcy system against the perceived danger to our financial markets posed by the disruptive effects of the automatic stay, the invalidation of bankruptcy default ("*ipso facto*") clauses, chapter 5 avoidance powers and other protections afforded to debtors. Initially limited to commodities contracts, Congress expanded the coverage and extent of the safe harbors in 1982, 1990, 1994, 2005 and 2006, successively sweeping in a wider variety of financial contracts. While many of these extensions clearly support the policy goal of protecting the financial markets from cascading failures resulting from the insolvency of a single firm, some commentators have argued that the safe harbors are now too broad in scope and hamper

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[24] *Cf.* 11 U.S.C. § 1129(a)(9)(A).

[25] *Cf.* 11 U.S.C. § 1129(a)(12).

[26] "Clear and convincing" is a term of art, describing an evidentiary standard higher than the "preponderance of the evidence" standard that governs by default in non-criminal cases, but lower than the "beyond a reasonable doubt" standard. *See Colorado v. New Mexico*, 467 U.S. 310, 316 (1984) (defining "clear and convincing evidence").

[27] *See In re Lehman Bros. Holdings*, 445 B.R. 143, 180 (Bankr. S.D.N.Y. 2011) (describing the role of the "melting ice cube" rationale in approving section 363 sales).

reorganizations without a corresponding benefit to any public financial market. The Report's recommendations appear intended to conform the scope of the safe harbors more closely to the original policy goal underpinning the existence of the financial contract safe harbors.

1. Limit on Section 546(e) Avoidance Safe Harbor for Private Leveraged Buyouts

Section 546(e) protects pre-petition "margin payments" and "settlement payments" made by or to a lengthy list of types of financial participants[28] in connection with a "securities contract" or "commodity contract" from avoidance by the debtor in possession on any ground except that the transfer was intentionally fraudulent. "Settlement payment," defined in sections 101(51A) and 741(8), is currently defined in a circular fashion to include a variety of settlement payments[29] and similar payments "commonly used in the securities trade." The term "securities contract" is similarly broadly defined, including, among other things, all contracts "for the purchase, sale, or loan of a security."[30]

Although there is a split in the way that courts apply the statute, the case law consistently supports the proposition that the "plain language" of section 546(e) protects shareholders receiving payments in leveraged buyouts, even of private companies, so long as a "financial institution" is used as an intermediary in connection with remitting the funds to be received by the shareholders in the transaction. This transaction could be as straightforward as a bank extending a loan, the proceeds of which are used to purchase equity of a privately held company from one or a small number of owners, provided that the lender pays the loan proceeds directly to the shareholders on the company's behalf.[31] Because the unwinding of such a transaction might be argued to pose only minimal risk to the proper functioning of the securities markets overall, the Commission has recommended that section 546(e) be clarified to carve out this particular category of purely private leveraged buyout transactions. Specifically, the Commission has recommended that section 546(e) no longer apply to avoidance actions against beneficial owners of privately issued securities in connection with pre-petition transactions that used some or all of the debtor's assets to facilitate the relevant transaction.

In contrast, the securities industry participants acting as conduits in private leveraged buyouts—such as a financial institution that receives funds for the benefit of shareholders and passes along those funds to the shareholders—would be expressly exempted from avoidance actions under the safe harbor, thereby eliminating any doubts about their protection under current law. Similarly, public securities holders would remain exempt, and likely would benefit to some degree from increased certainty due to the harmonization of the language of the statute with the motivating policy. However, both securities industry intermediaries and public holders would still be vulnerable to avoidance actions premised on *actual* fraudulent intent.

[28] Including "a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency." 11 U.S.C. § 546(e).

[29] *See, e.g.*, 11 U.S.C. § 741(8) ("'settlement payment' means a preliminary settlement payment, a partial settlement payment, an interim settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade"). Section 101(51A)'s definition is similar.

[30] 11 U.S.C. § 741(7).

[31] *See, e.g.*, *Geltzer v. Mooney (In re MacMenamin's Grill Ltd.)*, 450 B.R. 414 (Bankr. S.D.N.Y. 2011) (declining to apply safe harbor as contrary to Congressional intent, but illustrating reach of the plain language, which in this case would have applied to an LBO of a bar and grill, initially owned by three shareholders, financed by a Small Business Administration loan).

Lastly, the Commission has recommended that the debtor in possession be permitted to avoid intentional fraudulent transfers under both section 548(a)(1)(A), as is the case currently, and section 544(b), which incorporates state law fraudulent transfer actions. Although section 544(b) would ordinarily allow the debtor in possession to pursue constructive fraudulent transfers as well, the proposed revision would only apply to intentional fraudulent transfers. As the federal law on intentional fraudulent transfers found in section 548(a)(1)(A) is largely, although not entirely, similar to the law of most states, this change is not likely to significantly expand the number of transactions vulnerable to avoidance. However, the extension would reduce the scope of a conflict in the case law although it would leave the greater part of the controversy unresolved.

Although the Commission has made a recommendation related to the scope of section 546(e),[32] it has not directly addressed what is perhaps the most significant issue in the safe harbor arena—where the estate declines to bring an avoidance action, whether counterparties to qualifying financial contracts are protected by the safe harbor against suits by non-debtors to the same extent they are protected from similar suits by debtors or chapter 11 trustees.[33] In what some have called a drafting error, section 546(e) appears to be expressly limited to suits by the debtor in possession or a bankruptcy trustee,[34] suggesting to some that creditors that obtain standing to bring state law fraudulent conveyance actions may do so notwithstanding the safe harbor provided by section 546(e). This has resulted in the creation of litigation trusts in some cases to bring actions against counterparties that were clearly protected from any action initiated by a debtor,[35] arguably undermining the protection Congress intended to grant to the financial markets under the safe harbors.

2. Walkaway Clauses, Repo Safe Harbors and Ordinary Supply Contracts

The Report suggests three other refinements to the safe harbors for financial contracts. First, the Report recommends amending the Bankruptcy Code to include a definition of "walkaway clauses" similar to the corresponding definitions in the Federal Deposit Insurance Act ("**FDIA**") and similar statutes.[36] "Walkaway clauses," also referred to as "one-way payment" and "limited two-way payment" clauses, allow non-defaulting counterparties to eliminate the benefit of a contract to the defaulting counterparty, even if the defaulting counterparty's position was "in the money." Walkaway clauses can significantly affect bankruptcy estates where debtors are deemed to be the defaulting party at the time of rejection,

[32] Briefly, the Commission has recommended that debtors in possession be permitted to bring both federal (section 548(a)(1)) and state law (section 544(b)) actions for *intentional* fraudulent conveyance. This is a minor change from current law, which already allows debtors to bring federal actions for intentional fraudulent conveyance under section 548(a)(1). The Commission was unable to reach consensus on any change to the current treatment of *constructive* fraudulent conveyance actions, which are in some ways further reaching and a source of uncertainty in a larger number of cases.

[33] *Compare Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) (construing similar language in section 546(g) to preempt state law causes of action) *with In re Tribune Co. Fraudulent Conveyance Litig.*, 499 B.R. 310 (S.D.N.Y. 2013) (finding that section 546(e) does not preempt state law causes of action).

[34] 11 U.S.C. § 546(e) ("Notwithstanding [sections related to avoidance], *the trustee* may not avoid a transfer…") (emphasis added); *see also* 11 U.S.C. § 1107(a).

[35] *See, e.g.*, *Weisfelner v. Fund 1* (*In re Lyondell Chem. Co.*), 503 B.R. 348 (Bankr. S.D.N.Y. 2014).

[36] The FDIA defines a walkaway clause as "any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of such party's status as a non-defaulting party in connection with the insolvency of an insured depository institution that is a party to the contract or the appointment of or the exercise of rights or powers by a conservator or receiver of such depository institution, and not as a result of a party's exercise of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law." 12 U.S.C. § 1821(e)(8)(G)(iii).

termination, liquidation or acceleration of a qualified financial contract. While this is consistent with the general policy of allowing certain financial contracts to operate inside bankruptcy as they normally would outside bankruptcy, it is an outlier as against other domestic insolvency regimes, such as the FDIA, the Orderly Liquidation Authority created by Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010[37] and the Insurer Receivership Model Act, promulgated by the National Conference of Insurance Commissioners. Each of those regimes renders walkaway clauses unenforceable.

The status quo for walkaway clauses in bankruptcy is unsettled; as with other areas where rights are not established by federal law, bankruptcy courts are left to look to state law to determine the rights of the parties.[38] The Report's recommendation would extend the rule observed in other insolvency regimes to the Bankruptcy Code, in an effort to resolve this uncertainty.

The Report endorses two reforms, in the alternative, to the treatment of the safe harbor for repurchase agreements or "repo" agreements. The preferred reform would be a rollback of the safe harbor to the kinds of agreements protected using the definitions of "repurchase agreement"[39] and "securities contract"[40] in place before the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("**BAPCPA**"). As a less far-reaching change, the Report alternatively recommends that the safe harbor be amended to exclude repurchase agreements that are, in substance, committed financing arrangements for mortgage loan portfolios.

Lastly, the Commission and commentators have identified an unintended expansion in the application of the safe harbors to "ordinary supply contracts," or contracts that are entered into in the ordinary course of business between non-financial sector firms. As with the Report's proposed changes to the treatment of private leveraged buy-outs, the concern here is that the special protections afforded financial contracts because of the unique nature of the financial markets should not be extended beyond the scope necessary to protect the financial markets.[41] Moreover, subsuming under the safe harbors ordinary supply contracts for the physical delivery commodities to be used by the debtor in its business reduces the ability of a debtor to restructure its operations through the assumption of favorable supply agreements (as opposed to bona fide hedging agreements). The Report suggests that the Bankruptcy Code be amended to allow consideration of: (i) whether the contract involved securities dealers or market makers or other parties; and (ii) whether the contract called for the physical supply of goods used, traded, or produced by the debtor in the ordinary course of its business.

E. Employee Issues

The Report's recommendations regarding labor and benefits issues aim to encourage consensual bargaining between debtors and their employees' labor representatives. In order to achieve these goals, the Commission's proposals include clarifications of procedures for negotiations concerning collective

[37] 12 U.S.C. § 5390(c)(8)(F)(i).

[38] *See, e.g.*, *Drexel Burnham Prod. Corp. v. Midland Bank PLC*, 92 Civ. 3098, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 10, 1992) (walkaway clause unenforceable under New York law).

[39] 11 U.S.C. § 101(47).

[40] 11 U.S.C. § 741(7).

[41] *See, e.g.*, *Lightfoot v. MXEnergy Elec., Inc. (In re MBS Mgmt. Servs.)*, 690 F.3d 352 (5th Cir. 2012) (payments by a residential real property management company to an electric company under a two-year contract which fixed the rate for electricity held to be payments under a "forward contract," and protected by the safe harbor).

bargaining agreements and retirement benefits, while also seeking to maintain flexibility so that the standards can be used effectively by a variety of debtors. The recommendations also aim to ensure protection of employee wages and benefits accrued and to be paid post-petition. Although the Commission's proposals would provide greater statutory guidance, the complexity and intricacies of these requirements, as well as the simple increase in number of requirements, could cause delays and implementation issues for debtors going forward.

1. Collective Bargaining Agreements Under Section 1113

In recognizing that employees and employee relations are vital to a debtor's successful reorganization and that rejection of a union collective bargaining agreement ("**CBA**") implicates labor as well as bankruptcy policies, and for this reason deserves heightened review, Congress enacted section 1113 of the Bankruptcy Code. Section 1113 establishes special procedures and standards that apply when a debtor seeks to modify or reject a CBA absent counterparty consent. Generally, the section outlines a bargaining process between the debtor and an authorized representative of the affected employees in order to facilitate a consensual modification of the CBA before a unilateral rejection by the debtor. Although the Report's recommendations will provide greater guidance for the negotiation process, the increased requirements, if implemented, likely could lead to delays in consensual CBA modification and/or rejection and increase the probability that the debtor or the authorized representative may run afoul of the added requirements.

Under section 1113, in order to make any change to a debtor's CBA, the debtor must submit a proposal of its modifications and meet and confer in good faith with the authorized representative in an attempt to reach a mutually acceptable modification. If no consensus is reached through the statutory bargaining process, the debtor may seek court-approved rejection of the CBA. A court may approve the debtor's motion to reject the CBA only if the debtor shows that: (i) it complied with the statutory bargaining and proposal requirements; (ii) the authorized representative refused to accept the debtor's proposal "without good cause"; and (iii) "the balance of the equities clearly favors rejection."[42] Despite laying the framework for a negotiation process aimed at achieving consensus, some commentators remain concerned that the current statute does not in practice foster meaningful negotiations and that courts generally approve a debtor's motions to reject a CBA when filed. The Report's proposed revisions to section 1113 seek to facilitate consensual modifications, clarify timelines and procedures and preserve labor relations, even if the CBA is ultimately rejected.

(i) Status Conferences and Tailored Timetables

First, the proposal establishes ostensibly clearer procedures and timetables by implementing specified status conferences with corresponding notice requirements, which allow the parties to create their own tailored timetables. Currently, section 1113 grants the debtor and the authorized representative wide discretion concerning the scheduling and substance of their negotiations to meet the statutory bargaining requirements. Notably, the Commission would add a new feature to section 1113 in the form of multiple bankruptcy court status conferences during the negotiation process. For the initial status conference, the debtor must submit notice of the request for the initial conference along with the debtor's proposal and

[42] 11 U.S.C. § 1113(c); *see Truck Drivers Local 807 v. Carey Transp. Inc.*, 816 F.2d 82, 93 (2d Cir. 1987) (detailing six factors to be considered in evaluating the balance of the equities).

required statutory information to the authorized representative within a reasonable time before the conference.

The initial conference is designed to serve as a forum for the debtor and the authorized representative to: (i) discuss the timetable for conducting negotiations over the proposal; (ii) resolve any initial issues regarding the disclosure of information for the evaluation of the proposal; (iii) identify any issues regarding the resources available to the parties so that they may engage in informed discussions regarding the request for modifications; (iv) discuss whether the participation of a mediator would assist the parties; and (v) discuss any other issues that may present obstacles to conducting informed, good faith negotiations. The Commission's proposal reflects the understanding that labor relations vary greatly between debtors and specific time frames and requirements would need to be tailored to each particular chapter 11 case. Under the Commission's proposed framework, the parties would develop their own deadlines and time frames in respect of their specific CBAs. The court would supervise the conference to ensure that negotiations are not merely a formality. The parties also may, but are not required to, engage the services of a mediator if they believe that it would benefit negotiations. Finally, statutory committees would be allowed to attend and observe these status conferences in order to evaluate the debtor's business judgment, but not to participate.

If, following the initial status conference and in accordance with the timetable established at that conference, the parties have not reached an agreement regarding the debtor's modification proposal, the debtor may request an additional status conference. The purpose of the second conference would be to inform the court of the parties' negotiation progress and for the trustee to request a case management process for a motion to reject the CBA. The Commission suggested that the proposed hearing schedule may incorporate a bifurcation of the trial into an initial hearing schedule for the presentation of the trustee's case, and a second hearing schedule for the authorized representative to present its case, to ensure that due consideration is given to each proposal. In order to balance the desire to achieve more consensual modifications against the practical reality that drawn-out negotiations may harm the estate, the Report proposes a 180-day deadline from the notice of request for an initial status conference for the trial on the debtor's motion to reject the CBA.

(ii) Treatment of Rejection of a CBA Under 1113

The Report's proposals with respect to section 1113 also address the current split in case law regarding treatment of rejection under section 1113 and the availability of rejection damages. Some courts have expressed the view that Congress implemented section 1113 to completely remove CBAs from the provisions of section 365, which provides for rejection damages if an executory contract is rejected in bankruptcy,[43] while other courts have adopted the approach that section 1113 should be read as supplementing the requirements of section 365.[44] The Report embraces the latter approach, clarifying that such damages would constitute general unsecured claims and be calculated based on the difference between the reductions implemented following rejection and the CBA terms prior to rejection. The Report notes that the availability of rejection damages would further the policy considerations of section 1113 as it may help the parties reach more frequent consensual resolutions during negotiation.

[43] *See, e.g.*, *In re Blue Diamond Coal Co.*, 147 B.R. 720 (Bankr. E.D. Tenn. 1992), *aff'd,* 160 B.R. 574 (E.D. Tenn. 1993).

[44] *Mass. Air Conditioning & Heating Corp. v. McCoy*, 196 B.R. 659, 663 (D. Mass. 1996) (citing *Norfolk and Western Railway Co. v. Am. Train Dispatchers Ass'n*, 499 U.S. 117, 136 n.2 (1991) (Stevens, J., dissenting)). *See also In re Moline Corp*., 144 B.R. 75, 78 (Bankr. N.D. Ill. 1992) (ruling that section 365 operates to fill in the gap left in section 1113 regarding rejection damages and that such omission was a legislative error).

2. Retiree Benefits and Section 1114

Section 1114 of the Bankruptcy Code provides that the debtor must timely pay certain retiree benefits and, similar to section 1113, follow a notice, disclosure and bargaining process before seeking to modify or terminate such retiree benefits during a chapter 11 case. In addition, the section grants administrative priority status to retiree benefits required to be paid before the effective date of a confirmed plan. Section 1114 broadly defines the term "retiree benefits" to include "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title."[45] Finally, the process by which retiree benefits may be modified parallels the section 1113 process for modification of a CBA, except that a committee authorized by the court serves as the "authorized representative" for retirees who are receiving benefits not covered by a CBA.

Currently, courts are split on the exact breadth of section 1114, specifically whether contractual rights under a retiree plan, fund or program overrule the requirements of section 1114. Some courts have held that a debtor is not required to comply with the section 1114 process when the debtor establishes that it has the right under the pre-petition program to unilaterally modify or terminate the benefits.[46] Other courts, including the Third Circuit Court of Appeals, have adopted a strict reading of the statute, finding that "[t]he fact that the debtor could have unilaterally stopped the payments had it not been in chapter 11 is . . . irrelevant."[47] This approach mandates that the debtor must continue to make retiree payments and engage in the section 1114 process during a chapter 11 proceeding regardless of the contractual provisions of the underlying plan, fund or program.

The Report recommends that section 1114 of the Bankruptcy Code be amended to clarify that the trustee must comply with this section even if the debtor contends that such benefits are terminable at will. However, the Commission tempered its proposal by noting that compliance with section 1114 should not create any new claims on behalf of retirees or otherwise affect the existence, nature or scope of any retirees' claims upon the termination or modification of such benefits under section 1114. Therefore, a debtor in possession could assert a "terminable at will" argument when objecting to the amount of any claim asserted by retirees brought after the parties had successfully engaged in the section 1114 negotiation process, but are still required to engage in the section 1114 process. The reasoning behind the proposal is based on the purpose and value of the section 1114 process itself. The procedures required by this section ensure that retirees have representation during the chapter 11 process. The section 1114 process also ensures that the proposed modifications to retiree benefits are made with adequate notice and understood by all affected parties.

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[45] 11 U.S.C. § 1114(a).

[46] *See, e.g., In re Gen. Motors Corp.*, No. 09-50026, Hr'g Tr. at 109:24-110:2 (Bankr. S.D.N.Y. June 25, 2009) ("Section 1114 doesn't apply to employee benefit plans that are terminable or amendable unilaterally by the plan sponsor."); *In re Delphi Corp.*, 2009 WL 637259, at *19 (S.D.N.Y. Mar. 11, 2009) ("[I]f, in fact, the debtors have the unilateral right to modify a health or welfare plan . . . the debtors' pre-Bankruptcy rights [are not] abrogated by the requirements of section 1114."); *In re N. Am. Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002); *Retired W. Union Employees Ass'n v. New Valley Corp.* (*In re New Valley Corp.*), 1993 WL 818245 (D.N.J. Jan. 28, 1993); *In re Doskocil Cos. Inc.*, 130 B.R. 870 (Bankr. D. Kan. 1991).

[47] *IUE-CWA v. Visteon Corp.* (*In re Visteon Corp.*), 612 F.3d 210, 222 (3d Cir. 2010).

Despite the noted benefits, the Commission's recommendations may have certain drawbacks or ultimately have little practical effect in chapter 11 cases. The Report notes that even if section 1114 applies to terminable benefits, the provision would not apply to the reorganized debtor. Therefore, the reorganized debtor could refrain from making its modifications until after it has emerged from bankruptcy. In addition, adoption of the proposal could lead to an increase in pre-petition termination of retiree benefits in anticipation of the statutory imposition. It is worth noting that any such pre-petition termination would be subject to a 180-day look-back period in bankruptcy.

3. Severance Benefits

Severance benefits generally take two forms: a lump sum payment due upon termination or an amount calculated based on the employee's length of service. For severance benefits that accrue post-petition, courts generally view lump sum severance benefits as post-petition administrative expenses. The Report proposes that section 503(b)(1)(A)(i) of the Bankruptcy Code be amended to include severance benefits among "wages, salaries, and commissions for services rendered after the commencement of the case."[48] The Commission views this as a technical correction to codify the approach that most courts already take and to compensate the employee for services rendered to the estate post-petition.

As for severance benefits calculated based on length of service, the Commission noted that some courts bifurcate the treatment of the severance benefit, with post-petition service accruing administrative claims and pre-petition service leading to pre-petition general unsecured claims,[49] whereas other courts, including the Second Circuit Court of Appeals, treat the entirety of severance benefits as leading to an administrative claim.[50] The Commission ultimately adopted the view that the Bankruptcy Code should specify treatment of both types of severance benefits. The Report recommends that the Bankruptcy Code be amended to clarify that the allocation approach should apply to length of service severance benefits because these benefits should be deemed accrued when such services are provided, that is in both pre- and post-petition allocations.

4. Wage and Benefits Priorities

Sections 507(a)(4) and (5) currently provide for the priority of wage and benefit claims of employees accrued within 180 days pre-petition up to $12,475 per employee for each claim.[51] In order to clarify these

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[48] 11 U.S.C. § 503(b)(1)(A)(i).

[49] *See, e.g., Preferred Carrier Svcs. Va., Inc. v. Phones For All, Inc.* (*In re Phones For All, Inc.*), 288 F.3d 730 (5th Cir. 2002); *Bachman v. Commercial Fin. Svcs., Inc.* (*In re Commercial Fin. Svcs., Inc.*), 246 F.3d 1291, 1294 (10th Cir. 2001); *In re Roth Am., Inc.*, 975 F.2d 949 (3d Cir. 1992); *Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks* (*In re Health Maint. Found.*), 680 F.2d 619, 621 (9th Cir. 1982); *Cramer v. Mammoth Mart, Inc.* (*In re Mammoth Mart, Inc.*), 536 F.2d 950 (1st Cir. 1976); *In re Public Ledger, Inc*., 161 F.2d 762 (3d Cir. 1947); *Rawson Food Svcs., Inc. v. Creditors' Comm*. (*In re Rawson Food Svcs., Inc.*), 67 B.R. 351 (Bankr. M.D. Fla. 1986).

[50] *Rodman v. Rinier* (*In re W.T. Grant Co.*), 620 F.2d 319 (2d Cir. 1980), *superseded by statute* (Bankruptcy Code) *as recognized in In re Hooker Investments, Inc.*, 145 B.R. 138 (Bankr. S.D. New York. 1992); *Straus-Duparquet, Inc. v. Local Union No. 3, Int'l Bhd. of Elec. Workers, AFL-CIO* (*In re Straus-Duparquet, Inc.*), 386 F.2d 649, 651 (2d Cir. 1967), *superseded by statute* (Bankruptcy Code) *as recognized in In re Drexel Burnham Lambert Grp., Inc.*, 138 B.R. 687, 711 (Bankr. S.D.N.Y. 1992). *See also Supplee v. Bethlehem Steel Corp*. (*In re Bethlehem Steel Corp.*), 479 F.3d 167, 175 (2d Cir. 2007) ("The key inquiry is whether the payment is a new benefit earned at termination or instead an acceleration of benefits [which the employee accrued over time].").

[51] The Report notes that the wage and benefit caps set forth in sections 507(a)(4) and 507(a)(5) are $11,725; however, as of April 1, 2013, these amounts were increased to $12,475.

provisions' application, the Report recommends combining section 507(a)(4) and (5) into a single priority rule with an aggregate cap of $25,000 per employee for wage and benefit claims accrued within 180 days pre-petition. The Report also notes that to the extent that the aggregate limit is insufficient to meet all such obligations, the cap should be applied first to wage claims in full, with the remainder, if any, applied to benefit claims. Finally, the Report recommends that section 549 be amended to clarify that the estate may pay up to the increased priority cap without order of the court. The Report notes that many debtors file first-day motions to continue payment of wages when the benefit provided by employees to the estate and these motions are practically universally accepted and uncontroversial. The suggestions seek to clarify the priority amounts and eliminate unnecessary legal and judicial expense.

F. Rights of Contract Counterparties

1. Limits on Critical Vendor Protections

The Report recommends that vendors' rights be scaled back somewhat in connection with goods delivered to the debtor shortly before the commencement of its bankruptcy case. The Report recommends the retention of section 503(b)(9), which allows vendors to assert administrative priority claims for goods delivered in the ordinary course of business within the 20 days immediately prior to the commencement of a case, subject to two clarifications. However, the Report recommends repeal of other vendor protections, including the elimination of section 546(c) and state law reclamation rights in bankruptcy, and the elimination of "doctrine of necessity" (so-called "critical vendor") claims by vendors whose claims for delivered goods are protected by section 503(b)(9).

The first clarification to section 503(b)(9) concerns the treatment of "drop shipments." In a drop shipment, a trade creditor supplies goods on the debtor's behalf to a third party. Some courts, reading the language of section 503(b)(9) closely, have held that in such a transaction, a debtor has never "received" the goods.[52] The Report recommends that the Bankruptcy Code be amended to overrule these cases, providing drop shipment vendors the same protections as vendors shipping directly to a debtor, so that vendors will not be discouraged from offering an otherwise desirable method of delivery, which is economically virtually identical to other deliveries of goods. The second clarification aims to regularize procedures for the assertion of section 503(b)(9) claims. Specifically, the Report recommends that section 503(b)(9) claims, like other claims, be subject to the filing of a proof of claim on or before the general bar date, or a bar date set specifically for section 503(b)(9) claims.

The retention of section 503(b)(9), first introduced by BAPCPA, is to be accompanied by the repeal of section 546(c) and the barring of state reclamation claims for the goods covered by section 503(b)(9). Section 546(c) provides a federal bankruptcy law conduit through which vendors are able to assert state law rights to reclaim goods delivered to the debtor within the 45-day period prior to the commencement of its case, provided that, along with certain other exceptions and defenses, the creditor's demand for such reclamation is timely[53] and the goods are not subject to a prior lien.[54] According to the Report, these

[52] *See, e.g.*, *Ningbo Chenglu Paper Prods. Mfg. Co. v. Momenta, Inc.*, 2012 U.S. Dist. LEXIS 122615, 2012 WL 3765171 (D.N.H. Aug. 29, 2012) (finding that debtor never had "received" goods drop shipped to a customer by the section 503(b)(9) claimant because the term "received" had to be given the same meaning in the section 503(b)(9) context as the reclamation context).

[53] That is, by the later of (i) 45 days after delivery of the goods or (ii) 20 days after the commencement of the case. 11 U.S.C. § 546(c)(1).

reclamations are relatively rarely invoked, and so the retention of section 503(b)(9) provides a superior and somewhat more uniform method of addressing the same vendor concerns about continuing to deliver goods to a distressed business.

Similarly, the Report appears to take the view that section 503(b)(9) is both duplicative of and preferable to arguments under the "doctrine of necessity" for the payment on an administrative priority basis of claims arising from the delivery of goods. The doctrine of necessity is often invoked to allow debtors to make payments to certain counterparties deemed critical to the debtor's continued operation, often referred to as "critical vendors." Many commentators point out that such payments do unwarranted violence to the priority scheme and the policy of equal distribution in bankruptcy, but most courts have been willing to invoke their equitable powers under section 105 of the Bankruptcy Code to permit at least some level of critical vendor payments under the rationale that such payments will help mitigate harm to the company's business and operations.[55] Although the Report argues for the retention, and indeed the codification, of the doctrine of necessity, it views section 503(b)(9) as a useful way to limit its application. If adopted, this reform would likely result in slightly reduced payments to critical vendors at the beginning of a case.

Notably, the Commission has not recommended a direct change to the status quo for critical vendors that provide services, rather than goods. Those critical vendors will instead be subject to the Commission's codified standard for the doctrine of necessity, which may prove to be more stringent than the prevailing standard.

2. Assumption of Executory Contracts

In addition to formally adopting the "Countryman" test for what constitutes an executory contract, the Report recommends some slight modifications to the assumption of executory contracts pursuant to section 365.[56] Under the proposal, a debtor would remain free from performance obligations under an executory contract from the commencement of its case until the assumption of that contract, provided that the debtor in possession pays on a timely basis for any goods or services provided post-petition under the contract. However, the rate for such post-petition payments would remain fixed at the pre-petition level, and not be subject to adjustments or modifications based on the debtor's bankruptcy filing, insolvency or pre-petition default. Further, debtors would not be required to cure historical non-monetary defaults prior to the assumption of an executory contract or unexpired lease if those defaults are impossible to cure at the time of the proposed assumption.

3. Rejection of Executory Contracts

The Report recommends that rejection of an executory contract should not entitle the non-breaching, non-debtor party to specific performance, notwithstanding its rights under state law. Additionally, the counterparty would not be permitted to retain possession or use of any property of the debtor or the

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(*cont.*)

[54] *See In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007) (describing extent of the "prior lien defense" and holding that reclamation rights are valueless where the prior lien exceeds the value of the goods).

[55] *See, e.g.*, *In re Just for Feet, Inc.*, 242 B.R. 821 (D. Del. 1999), *but see*, *In re Kmart Corp.*, 359 B.R. F.3d 866 (7th Cir. 2004).

[56] The often-cited Countryman definition of an executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

estate, unless expressly authorized by a provision in the Bankruptcy Code.[57] However, if the non-debtor party to an executory contract or unexpired lease breaches the contract prior to the debtor's decision to assume or reject, the debtor would be able to exercise any rights or remedies it would have under the contract or lease, or under applicable non-bankruptcy law.

4. IP Licenses and Trademarks

The Report recommends a rollback of certain protections currently afforded non-debtor licensors of intellectual property. Ordinarily, debtors are permitted to assign executory contracts[58] notwithstanding applicable non-bankruptcy law or provisions to the contrary contained therein.[59] Intellectual property licenses are currently one of the rare exceptions to this rule.[60]

Under the proposed revision, the Bankruptcy Code would expressly authorize a debtor in possession to assume an intellectual property license, effectively overturning case law following the so-called "hypothetical test," under which a debtor may only assume contracts that it is able to assign.[61] Thus, even where the revised law continued to prohibit assignment of an intellectual property license, the debtor would not be deprived of the benefit of its license merely by reason of its bankruptcy.

In a sharper deviation from current law, the Report further recommends that intellectual property licenses should be freely *assignable*, subject to objection by the licensor. The licensor, upon appropriate notice and a hearing, would be required to show that the hardship imposed by assignment significantly outweighs the benefit to the estate. The Commission appears confident that such a showing would be possible where a debtor proposed to assign its license to a competitor of the licensor, although in every case the licensor would carry the burden of proof.

The Report also recommends that "trademarks," "service marks" and "trade names" be included in the Bankruptcy Code's definition of "intellectual property," in order to resolve lingering uncertainty around their treatment in bankruptcy. Trademarks were intentionally omitted by Congress from the 1988 amendments to the Bankruptcy Code, which added the first of the existing protections for intellectual property licensors and licensees. Concerns about the unique role that trademarks, service marks and trade names play in the market, as well as regarding debtors' ability to effectively exercise quality control over their licensees, caused Congress to leave the treatment of such marks to the courts for further development. As a consequence, non-debtor licensees of trademarks do not benefit from the protections afforded by section 365(n), which allows other non-debtor licensees of intellectual property to treat rejected licenses either as terminated or as effective through the end of the remaining term. At the same time, the lack of statutory direction has resulted in competing approaches among the courts, ranging from

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[57] *See, e.g.*, 11 U.S.C. § 365(n).

[58] Intellectual property licenses are generally treated as executory contracts. *In re Kmart Corp.*, 290 B.R. 614, 619 (Bankr. N.D. Ill. 2003), *see also Beuna Vista TV v. Adelphia Communs. Corp. (In re Adelphia Communs. Corp.)*, 307 B.R. 404, 427 n. 102 (Bankr. S.D.N.Y. 2004) (collecting cases).

[59] *See* 11 U.S.C. § 365(f).

[60] *See, e.g.*, *Perlman v. Catapult Entm't (In re Catapult Entm't)*, 165 F.3d 747 (9th Cir. 1999) (patents are neither assumable nor assignable under section 365(c)(1)).

[61] *See, e.g.*, *In re West Elec. Inc.*, 852 F.2d 79 (3d Cir. 1988).

rejection resulting in immediate termination of the licensee's right to use the trademark,[62] rejection resulting only in a breach on the debtor's behalf, with the licensee free to exercise its rights under the agreement and applicable non-bankruptcy law,[63] rulings that some trademark licenses are not executory contracts at all,[64] to the application of section 365(n) on an equitable basis to the rejection of a trademark license.[65]

In connection with the extension of the definition of "intellectual property" to cover trademarks, service marks and trade names, the Report recommends slight modifications to section 365(n) to address the unique concerns associated with that intellectual property. A non-debtor licensee electing to retain its rights under section 365(n) would be required to comply in all respects with the license and related agreements, including with respect to (i) products, materials and processes permitted or required to be used in connection with the licensed mark and (ii) its obligations to maintain the sourcing and quality of the products or services offered.

Additionally, the Report recommends that the definition of "intellectual property" in the Bankruptcy Code[66] be amended to include foreign patents, copyrights and trademarks in order to harmonize the treatment of foreign and domestic intellectual property.[67]

5. Real Property Leases

The Report proposes several refinements of the treatment of unexpired non-residential real property leases. In response to concerns that the current maximum 210-day time limit for assumption or rejection[68] has rendered bankruptcy particularly undesirable and sometimes non-viable for businesses with numerous material leases, and in particular for retail businesses, the Report recommends that debtors instead be given one year after the petition date to make their decision to assume or reject unexpired non-residential real property leases.

For purposes of calculating post-petition rent, the Report recommends the adoption of the "accrual method," under which rent attributable to days in the billing period prior to the petition date is treated as a pre-petition obligation, and rent attributable to the time after the petition treated as a post-petition obligation. This is in contrast to the "billing method," under which the actual date of the bill or invoice governs whether the rent is treated as pre- or post-petition.

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[62] *See, e.g.*, *In re Old Carco LLC*, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009), *aff'd sub nom. Mauro Motors Inc. v. Old Carco LLC*, 420 F. App'x 89 (2d Cir. 2011).

[63] *See, e.g.*, *Sunbeam Prods., Inc. v. Chicago Am. Mfg., LLC*, 686 F.3d 372 (7th Cir. 2012).

[64] *See, e.g.*, *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010).

[65] *See, e.g.*, *In re Crumbs Bake Shop, Inc.*, 2014 Bankr. LEXIS 4568, 2014 WL 5508177 (Bankr. D.N.J. Oct. 31, 2014).

[66] 11 U.S.C. § 101(35A).

[67] Some bankruptcy courts have expressed concern about the disparate treatment of foreign and domestic intellectual property, particularly in the context of multinational enterprises. *See, e.g.*, *In re Qimonda AG*, 52 Bankr. Ct. Dec. 127, 2009 Bankr. LEXIS 3786, 2009 WL 4060083 (Bankr. E.D. Va. Nov. 19, 2009) ("All the patents should be treated the same. There should not be disparate results simply because of the location of a factory or research facility or corporate office."), *rev'd sub nom. Micron Tech., Inc. v. Qimonda AG (In re Qimonda AG)*, 433 B.R. 547 (E.D. Va. 2010).

[68] Section 365(d)(4) presently requires assumption or rejection of a non-residential lease of real property within 120 days after the filing of the petition, subject to one 90-day extension.

G. Plan Process

The Report makes several recommendations with respect to the chapter 11 plan process that are intended to clarify procedures and facilitate debtors achieving plan confirmations. These proposals focus on protecting junior creditors' rights, funneling structured chapter 11 dismissals into plan confirmations and clarifying standards for certain chapter 11 plan provisions. If adopted, these proposals could result in a decrease in strategic purchasing of claims for chapter 11 voting purposes, an increase in chapter 11 plans (as opposed to dismissals) and a restoration of voice to "silent second lien" holders.

1. Contractual Assignment and Waiver of Plan Voting Rights Unenforceable

Modern debtors often have multiple secured creditor classes. To structure their debt and attempt to provide certainty of treatment to the different classes, corporate borrowers and their secured creditors often enter into subordination or intercreditor agreements that contractually provide for the priority of payment between the different creditor groups. Intercreditor agreements may also address other issues relating to debtors and collateral, including among others, limiting junior creditors' rights to: (i) request adequate protection; (ii) offer or participate in post-petition financing for the debtor; (iii) foreclose on collateral; and/or (iv) vote on a chapter 11 plan in any chapter 11 case. The Commission focused its inquiry on the enforceability of provisions in intercreditor agreements granting the authority to assign or waive a creditor's chapter 11 plan voting rights, while acknowledging that section 510(a) of the Bankruptcy Code broadly recognizes the enforceability of pre-petition intercreditor and subordination agreements during a bankruptcy case.[69]

Although payment terms of intercreditor agreements are generally enforced, some commentators have questioned whether creditors should be permitted to affect or waive specific bankruptcy rights prior to or in contemplation of a bankruptcy filing, specifically plan voting rights.[70] Courts that have declined to enforce assignments of voting rights or waivers of voting rights in chapter 11 cases have found a basis for their decision in section 1126(a). These courts emphasized that the plain language of this section states that only "holder[s] of a claim . . . under section 502 of this title may accept or reject a plan."[71] A strict reading of this section would imply that provisions assigning voting rights without assigning the corresponding claim are unenforceable. Relatedly, courts have also questioned the ability of parties to contractually waive voting rights, which are created by and only available in a chapter 11 case under federal bankruptcy law.[72] Other courts have read section 1126(a) more broadly, noting that it does not expressly prohibit the delegation of rights associated with claims held by a creditor.[73] This interpretation

[69] 11 U.S.C. § 510(a) ("A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law.").

[70] Sharon L. Levine et al., *If You Assign Your Plan Vote—Mean It*, LAW360, July 9, 2013, 5:35 p.m. (discussing recent trends in the enforcement of assignment provisions under subordination agreements). *See also* Edward Rust Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 ILL. L. REV. __, at *11 (forthcoming 2015) (suggesting that waivers and assignments in an intercreditor agreement should only be enforced if it is "unlikely to affect the outcome of the Chapter 11 process (sale versus reorganization, or confirmation of one plan versus another) and primarily to affect the distributions of parties to the agreement") (draft on file with Commission). *See generally* Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. PENN. J. BUS. L. 35 (2009) (discussing claims assignment in bankruptcy generally).

[71] 11 U.S.C. § 1126(a).

[72] *In re Hart Ski Mfg. Co., Inc.*, 5 B.R. 734 (Bankr. D. Minn. 1980).

[73] *See, e.g., Blue Ridge Investors II, LP v. Wachovia Bank, N.A.* (*In re Aerosol Packaging, LLC*), 362 B.R. 43, 45–47 (Bankr. N.D. Ga. 2006).

follows a strict reading of section 510(a) and emphasizes that the only qualification to the enforcement of an intercreditor agreement should be if it is unenforceable under state law.

The Report proposes that contractual assignments or waivers of voting rights in favor of senior creditors in an intercreditor, subordination or similar agreement should not be enforced. This recommendation seeks to balance two key policy considerations: respecting the private contractual rights of non-debtor parties and fostering the underlying goals of chapter 11. The Commission ultimately concluded that the ability of non-debtor parties to affect the rights of the debtor and other stakeholders in chapter 11 cases through voting provisions (for example, by controlling the plan vote and thereby influencing the ultimate plan structure) undermines the core protections the voting provisions seek to grant to junior creditors.

If adopted, this recommendation would signal a shift in leverage between first and second (and third) lien creditors, ensuring at least that junior creditors' chapter 11 voting rights could not be assigned or waived. However, many contemporary intercreditor agreements contain further nuanced voting provisions requiring that a creditor vote or refrain from voting in a certain manner—for example, a junior creditor may agree that it will not support or vote for a chapter 11 plan where the senior creditor is not paid in full in cash or that the senior creditor does not support. The Commission discussed these types of additional voting limitations but did not prohibit them, deciding only to render unenforceable provisions that assign or waive a creditor's voting rights.

2. No Structured Dismissals

Generally, a debtor can exit a chapter 11 bankruptcy proceeding in one of three ways: (i) confirmation of a plan under section 1129; (ii) conversion of the case under section 1112; or (iii) dismissal of the case subject to section 349. In recent years, bankruptcy courts have encountered an exit strategy that does not neatly fit into one of these three categories, referred to as a "structured dismissal." Structured dismissals can be viewed as a combination of a dismissal and confirmation order, in that they usually dismiss the chapter 11 proceeding while at the same time obtaining court approval of certain confirmation order-like arrangements in the dismissal order. These arrangements are typically the result of detailed negotiations and settlements between debtors and creditors. Common features of a structured dismissal may include, among others, that substantially all of the debtor's assets have been sold pursuant to a section 363 sale, the debtor's estate is essentially reduced to cash to be distributed, inclusion of an alternative claims allowance process and third-party release provisions. In short, structured dismissals are dismissal orders that provide for more than a "plain vanilla" dismissal.

The Report seeks to resolve the controversy concerning whether bankruptcy courts have the authority under the Bankruptcy Code to grant structured dismissals. Section 305(a) allows a bankruptcy court to dismiss or suspend a case if "the interests of creditors and the debtor would be better served by such dismissal or suspension."[74] In addition, section 349 details the effects of a dismissal order, providing that upon issuance such an order reinstates certain liens and actions, vacates certain orders and returns certain property to its pre-petition owner. Opponents of structured dismissals focus on the legislative history and stated purpose of section 349, which notes that "[t]he basic purpose of [section 349] is to undo the bankruptcy case as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case."[75] On the other hand, proponents of structured

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[74] 11 U.S.C. § 305(a).

[75] H.R. REP. NO. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6294. *See also Armel Laminates, Inc. v. Lomas & Nettleton Co.* (*In re Income Prop. Builders, Inc.*), 699 F.2d 963, 965 (9th Cir. 1982) ("11 U.S.C. § 349, treating the effects of a bankruptcy, (*cont.*)

dismissals argue that the Bankruptcy Code does not contain an explicit prohibition against these types of dismissals and cite their practicality and efficiency for chapter 11 debtors. In particular, structured dismissals allow for chapter 11 debtors to exit bankruptcy quickly and cleanly without dissipating assets and value of the estate through a lengthy confirmation process.

The Report recommends that the Bankruptcy Code be amended to clarify that strict compliance with sections 1129, 1112 or 349 are the only methods by which a debtor may exit chapter 11, and as such structured dismissals are not permitted. The recommendation is based on the policy that creditor protections provided in connection with the confirmation of a plan should not be short-circuited by structured dismissals. In particular, the Commission found that structured dismissals in practice often allow for the debtor to bypass disclosure and solicitation requirements contained in the confirmation process to protect creditors. However, the Report notes that debtors should have the ability to sell all or substantially all of their assets under section 363(b) when that strategy proves to be the best and most efficient method to maximize value for the estate. As such, the Report also recommends the inclusion of specific provisions to address the sale of all or substantially all of a debtor's assets under section 363x, believing these provisions will render the use of structured dismissals unnecessary. If adopted, the Report's recommendations could make certain chapter 11 proceedings longer and more costly.

3. Other Recommendations—Facilitating Plan Confirmation

(i) Numerosity Calculated as "One Creditor, One Vote"

The Report recommends amending section 1126(c) such that the numerosity requirement for a class of creditors to vote to accept a plan would be calculated as "one creditor, one vote" as opposed to by number of claims held. Section 1126(c) provides that a class of creditors has accepted a plan if creditors "that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors" accept.[76] Whether the "one-half in number" requirement has been satisfied has been interpreted to mean that both one-half of the creditors in the class and one-half of the claims in the class must accept. In certain circumstances, courts have found that one creditor has the right to vote multiple times to meet the numerosity requirement where their claims are sufficiently "separate" to warrant more than one vote.[77] The Report notes that the lack of clarity on this issue has led to substantial gamesmanship and diversion of resources to obtain the numerosity requirement.

(*cont.*)

obviously contemplates that on dismissal a bankrupt is reinvested with the estate, subject to all encumbrances which existed prior to the bankruptcy. After an order of dismissal, the debtor's debts and property are subject to the general laws, unaffected by bankruptcy concepts. After dismissal a debtor may file another petition for bankruptcy unless the initial petition was dismissed with prejudice."); *Citizens First Nat'l Bank of Princeton v. Rumbold & Kuhn, Inc.* (*In re Newton*), 64 B.R. 790, 793 (Bankr. C.D. Ill. 1986) ("[T]o the extent possible a dismissal of a petition reverses what has transpired during a bankruptcy."); *In re Safren*, 65 B.R. 566, 571 (Bankr. C.D. Cal. 1986) ("The objective of section 349(b) is to restore all property rights, insofar as is practicable, to their positions when the case was filed.").

[76] 11 U.S.C. § 1126(c).

[77] *Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am.* (*In re Figter Ltd.*), 118 F.3d 635 (9th Cir. 1997), *cert. denied*, 522 U.S. 996 (1997); *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989). *See also* Wendell H. Adair, Jr. & Kristopher M. Hansen, *One Claim, One Vote: The Purchase of Claims to Avoid Cramdown*, J. CORP. RENEWAL, Jul 1, 2000 ("Once again citing the voting formula contained in Section 1126(c) of the Bankruptcy Code, the court held that acceptance or rejection of a plan by a class of creditors is determined by "the number of claims, not the number of creditors, that actually vote for or against a plan."), *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=1294

To clear up any confusion, the Report proposes that all affiliated entities under common investment management should be treated as a single creditor. If adopted, the recommendation may lead to a decrease in strategic purchases of claims within a class of creditors and more frequent plan acceptances. The proposal could have a particularly sharp effect on large institutions and investors with multiple affiliates or funds that are creditors in the same class; the recommendation would mean that all such affiliates or funds (even ones separately managed and separated by ethical or governance "walls") would be treated as one creditor for voting purposes.

(ii) No Impaired Consenting Class Necessary

The Report further recommends the elimination of section 1129(a)(10), which requires acceptance of a plan by at least one class of claims impaired under the plan. The Report notes that this provision is often used to prevent a debtor or plan proponent from confirming a plan under the cramdown provisions of 1129(b) or may lead to a debtor or plan proponent constructing an artificially impaired class simply to satisfy the provision. Although the Report recognizes that the provision may improve the perceived integrity of a chapter 11 plan, it often offers no substantive creditor protection as it can often be easily manufactured, and in practice it tends only to allow parties to stall the confirmation process.

(iii) Silence Is Not Assent

In conjunction with the above recommendations, the Report proposes that the Bankruptcy Code should be amended to clarify that a chapter 11 plan cannot specify that a class's failure to vote will be deemed acceptance of the plan by that class. The Commission weighed the plain meaning of the Bankruptcy Code, noting that Congress explicitly provided for deemed consent in other sections (specifically, unimpaired classes) against the policy consideration that a class that does not participate in the voting process may unwittingly delay confirmation of the plan. Ultimately, the Report argues that the recommendation to eliminate section 1129(a)(10) (the requirement to have an impaired consenting class to effectuate a cramdown) lessens the need to proactively provide for a class's deemed acceptance of a chapter 11 plan. If this recommendation is adopted, certain plan confirmations may be delayed by the need to obtain actual acceptance of the plan from a class or alternatively cram down the class.

(iv) Expansion of the Vote Designation Standard

The Report recommends that when determining whether to "designate," or disallow, a creditor's vote under section 1126(e), courts should consider whether the creditor's vote was "manifestly adverse" to the economic interests of the general creditors in the class, in addition to the current standard of whether the vote was cast in bad faith. This represents a softening of the original "bad faith" standard, which is often described as a "heavy burden of proof."[78] The Report notes that not every apparent conflict of interest should require designation under section 1126(e), but states that even where the high standard of bad faith is not apparent, when a creditor has a conflict of interest and is the only creditor in the class to vote against the plan, this conduct may be sufficiently harmful to the economic interests of the other class creditors to warrant designation. This standard, if adopted, may lead to increased frequency of attempts to designate votes under section 1126(e), as well as increased litigation in connection with such efforts.

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[78] *See, e.g., In re Adelphia Commc'ns Corp*., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) ("The party seeking to have a ballot disallowed has a heavy burden of proof.").

(v) Plan Exculpations and Third-Party Releases

The Report recommends amending sections 1125(e) and 1129 to clarify that, subject to the below applicable standards, chapter 11 plans may contain exculpation and third-party releases. These recommendations are aimed at encouraging professionals and other third parties to aid the estate before and during the chapter 11 process. Although these proposals share a similar motivation, the Report recommends that different standards should be applicable to each.

For exculpation clauses, the Report recommends a simple negligence standard only available to estate representatives and their professionals, while noting that exculpation clauses may also be extended to other parties on a case-by-case basis.

For third-party releases, the Report rejects both a blanket acceptance/rejection standard and the Delaware seven-factor approach in *Dow Corning*,[79] and instead endorses the five-factor test articulated in *Master Mortgage.*[80] This test requires the consideration and balancing of each of the following factors: (i) the identity of interests between the debtor and the third-party, including any indemnity relationship, and the impact on the estate of allowing continued claims against the third-party; (ii) any value (monetary or otherwise) contributed by the third-party to the chapter 11 case or plan; (iii) the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts; (iv) the level of creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release. For both exculpation and third-party release provisions, the recommendations would require them to be clearly stated in the chapter 11 plan and disclosure statement. If implemented, these recommendations would provide clearer and more uniform guidance for courts reviewing exculpation and third-party release provisions, as well as providing more certainty regarding the potential liability of parties' professionals and other representatives working with the debtor during the chapter 11 process.

(vi) Validation of the New Value Exception

The Report recommends codification of the new value exception to the absolute priority rule. Generally, under the absolute priority rule, a pre-petition equity security holder cannot retain or receive new equity on account of its previous holdings unless all creditors are paid in full under the plan. However, some courts have held that where the pre-petition equity holder contributes new money or new money's worth to the debtor and this opportunity is not exclusive to the pre-petition equity holders, the holders may gain or retain an equity interest in the reorganized debtor. In making this recommendation, the Report focuses on the practical benefit the new value exception may have on facilitating plans of reorganization, noting that many times pre-petition equity holders are the most likely source of funding for the chapter 11 plan.

Accordingly, the Report recommends that the new value exception be codified to require (i) new money or new money's worth; (ii) in an amount proportionate to the equity received or retained by pre-petition equity security holders; and (iii) subject to a "reasonable" market test. Note that the Commission declined to further elaborate regarding what would be required under a "reasonable" market test but indicated that it would be less strict than a formal market test. The implementation of this recommendation would, in certain cases, provide a wider range of available funding sources for chapter 11 plans.

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[79] *In re Dow Corning Corp.*, 280 F.3d 648 (6th Cir. 2002), *cert. denied*, 537 U.S. 816 (2002).

[80] *In re Master Mortg. Inv. Fund Inc.*, 168 B.R. 930 (Bankr. W.D. Mo. 1994).

H. *In Pari Delicto* Doctrine

The Report recommends the elimination of the *in pari delicto* defense for cases involving chapter 11 trustees. While this change would apply only in the unusual cases where a debtor in possession has been displaced by a court-appointed trustee, it may have far-reaching consequences for the pursuit of claims against both former insiders and their advisors.

The *in pari delicto* doctrine (meaning "in equal fault") generally bars the pursuit of a cause of action by a plaintiff who was complicit in the alleged wrongdoing. Although clearly supported by strong policy arguments outside the bankruptcy context, the extension of the *in pari delicto* doctrine to debtors in possession, who are pursuing claims on behalf of the bankruptcy estate and therefore for the benefit of their creditors, has sometimes led to perverse results. This is acutely the case when the debtor's causes of action are being brought by a court-appointed trustee whose relation to the debtor-wrongdoer is at most a legal fiction, and may even be adversarial. Nonetheless, every Circuit Court of Appeals except for the Ninth Circuit has held that the *in pari delicto* doctrine is available to defendants against claims asserted under section 541 by either a debtor in possession or a chapter 11 trustee, subject to narrow exceptions.

Against the benefit to the estate of eliminating this defense, the Commission considered the danger of opening relatively innocent third parties to suits that may lack in merit and for which the debtor may have been the principal wrongdoer. If adopted, professional advisors and institutions in the distressed space might potentially face heightened litigation risk due to failure to detect a client's wrongdoing. This would be the case even if the debtor's pre-petition actions were intentionally wrongful, while its advisors were merely negligent.

In light of these competing considerations, the Report cabins its recommendation to abrogation of the defense as against chapter 11 trustees only, and not against debtors in possession, estate neutrals, unsecured creditors' committees or other interested parties.

I. Estate Neutrals and Governance

1. The Expanded Role of the Estate Neutral

Section 1104(c) requires the appointment of an examiner, on motion of a party, if the appointment would be in the interest of the estate or if the debtor's unsecured debts exceed $5 million. The examiner can promote efficiency by navigating among a multiplicity of parties and investigations, however the examiner's role is largely limited to performing an investigation and submitting a lengthy report. In recent years, courts and debtors have increasingly turned to other third parties, such as mediators, as independent estate neutrals that can navigate multi-creditor and multi-debtor disputes more nimbly than the court.

Recognizing the value of these non-examiner estate neutrals, the Report proposes an amendment to section 1104 that would broaden the range of purposes for which an estate neutral can be appointed and permit the court to appoint more than one estate neutral in any given case for different purposes. The Commission considered that examiners are uniquely neutral and independent, and they may be able to identify value, encourage parties to recognize the strengths and weaknesses of their positions in the case and facilitate quicker resolution of disputes. Their role could also be expanded to include facilitating dispute resolution and reducing information asymmetry.

The Commission also considered that the mandatory language of section 1104(c), which requires appointment of an examiner if the debtor's unsecured debts exceed $5 million, may not be necessary. Examiners are not beneficial to every large chapter 11 case, and similarly, estate neutrals may not be. Indeed, many courts have struggled with the mandatory language of section 1104(c), sometimes refusing to appoint an examiner even where plainly required and other times appointing an examiner but refusing to fund it.[81] To fix this problem, the Report recommends eliminating the mandatory language of section 1104(c) and replacing it with a standard that permits the court to order the appointment of an estate neutral if (i) a trustee is not appointed, and (ii)(a) the appointment is in the best interests of the estate or (b) for cause.

2. Role of Debtor in Possession: Authority and Fiduciary Duties

The Bankruptcy Code refers to applicable state law to define the obligations imposed on the management of a debtor in possession, specifically the authority to take certain fundamental actions and fiduciary duties. Generally, state law may impose certain requirements before a debtor in possession can take fundamental actions—for example, obtaining shareholder approval before selling all or substantially all of the debtor's assets—and imposes the duties of care, loyalty and an obligation of good faith upon the debtor's board of directors. Adherence to state law procedures regarding governance can often add significant delay to the reorganization process and allow shareholders the opportunity to influence the estate when their interests may not be aligned. With respect to plan implementation, state law is often ambiguous as to whom the fiduciary duties are owed, the estate (including unsecured creditors) or the reorganized company.

Regarding the authority of a debtor in possession, the Report recommends amending sections 1107, 1141 and 1142 of the Bankruptcy Code to clarify that these provisions preempt state law and that a debtor in possession need not strictly follow the procedures prescribed by state law concerning the sale of all or substantially all of its assets, plan implementation or annual equity holder meetings. The Commission found that adherence to state law procedures in these matters often imposes significant cost and delay on the estate. The Report recommends expressly granting the debtor in possession the authority to sell all or substantially all of its assets and engage in transactions necessary to implement a plan of reorganization without seeking approval of its shareholders.

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

With respect to annual shareholder meetings, the Report does not recommend a flat prohibition, but proposes that whether a meeting be granted should be determined on a fact-intensive inquiry given the governing state law and facts of the particular case.

Concerning a debtor in possession's fiduciary duties, the Report recommends amending section 1121 to specify that in regards to plan process the debtor in possession does not act as a fiduciary of the estate and to benefit the unsecured creditors, but owes its fiduciary duties to the entities specified under state law (most often the company itself and its shareholders). The Commission found that a debtor in possession cannot sufficiently represent both the interests of itself and its shareholders as well as the interest of the estate and its creditors during the plan process. In forming its proposal, the Commission focused on the Bankruptcy Code's distinction between the "debtor in possession" and the "debtor." When a debtor in possession proposes a plan of reorganization, the Code states that it is on behalf of the "debtor" as opposed to the "debtor in possession," which is used interchangeably with the "trustee" under the Bankruptcy Code and whose fiduciary duties are specified as owed to the estate and its creditors. In contrast, the Report also recommends that section 327 be amended to clarify that professionals for the debtor in possession can act as an estate fiduciary and in a separate capacity as a debtor fiduciary without violating this section.

These recommendations will clarify the role of the debtor in possession during the plan process and expedite the debtor in possession's ability to take certain actions. If implemented, these recommendations could streamline the reorganization and plan confirmation process in some respects and provide greater clarity regarding fiduciary duties to debtors and their stakeholders.

3. Creditors' Committees

The Report proposes to modify section 1102(a) only slightly, providing that the appointment of an unsecured creditors' committee should remain mandatory as under current law but adding that the court may order otherwise for cause. The term "cause" in these circumstances includes that the appointment would not be in the best interests of the estate or that the interests of general unsecured creditors do not need representation because, for example, they will not receive any distribution or will be paid in full, as is the case under many pre-packaged chapter 11 plans. The court, U.S. Trustee or a party in interest could initiate a hearing to determine whether the appointment or continuation of an unsecured creditors' committee is in the best interests of the estate.

This recommendation represents a compromise among the Commissioners regarding the continued efficacy of mandatory creditors' committee appointments. Some Commissioners believed that mandatory appointment was no longer necessary because in many large contemporary chapter 11 cases a secured class represents the fulcrum security or unsecured creditors are either being paid in full or receiving no distribution. Ultimately, the Commission was convinced that creditors' committees continue to serve a valuable "watchdog" function in chapter 11 cases and that they should be appointed except where certain conditions exist making their appointment notably less useful.

Although this paper does not address specific proposals aimed at small and medium sized enterprise ("**SME**") bankruptcy cases, it is worth noting that the Commission recommends that an unsecured creditors' committee should *not* be appointed in an SME case unless an unsecured creditor or the U.S. Trustee files a motion requesting the appointment and the court determines that the appointment is necessary to protect the interests of unsecured creditors.

J. Valuation

1. Valuation Information Package

The Report recommends a substantial overhaul of the disclosures required of debtors in chapter 11. Although debtors are currently obligated to provide a number of disclosures upon filing, the Commission concluded that current disclosure rules do not give parties in interest sufficient information regarding the valuation of the debtor's business and assets early in the case. Significant information asymmetries often exist between various stakeholders that heighten the difficulty of evaluating possible exit strategies and creditors' recoveries. Therefore, the Report proposes that a debtor be required to compile a "valuation information package" ("**VIP**"), likely in preparation for filing. The proposed VIP would contain: (i) tax returns for the previous three years (including schedules); (ii) annual financial statements (audited if available) for the prior three years; (iii) the most recent independent appraisals of any of the debtor's material assets (including valuations of the business enterprise or equity); and (iv) to the extent shared with pre-petition creditors and existing or potential purchasers, investors, or lenders, all business plans or projections prepared within the prior two years.

A list of the materials contained in the VIP would be filed with the court in connection with any motion under any of sections 361, 362, 363 or 364 or any plan of reorganization filed within the 60 days immediately following the filing of the petition. The VIP itself would not be publicly available. Because post-petition financing is often sought at the beginning of a case under section 364, this list would often be filed as part of the "first day" pleadings. A party in interest may, on motion, request the VIP for a proper purpose, including evaluation of the pending motion or proposed plan. The debtor would then promptly provide the VIP, unless the court orders otherwise.

In order to mitigate risks to the debtor's confidential information and business strategy, access to the VIP would be subject to appropriate provisions regarding confidentiality and fiduciary outs. Additionally, the debtor would be able to redact or withhold information otherwise required to be included in its VIP to the extent that the debtor determines in good faith that such redaction would be necessary to prevent harm to the estate, unless the court orders otherwise.

2. Court-Appointed Valuation Expert

Although the Commission dedicates a section of its Report to the topic of court-appointed valuation experts, it actually suggests no change in the law. Courts are already empowered to appoint experts to assist them with, among other things, testing the valuations presented before them or even formulating independent valuations.[82] Court-appointed experts must testify in the case, rather than privately advising the court, and are subject to cross-examination. While the Report endorses the statutory status quo, it encourages courts to use this rarely invoked power in cases where an independent evaluation expert would be of assistance.

[82] *See* 11 U.S.C. § 105, Fed. R. Evid. 706.

III. Conclusion

Given recent developments in cases such as *ResCap*, *Momentive*, *Fisker* and others, it is clear that, whether or not any of the Report's recommendations are adopted, there will be significant pressure on secured lenders and investors in chapter 11 cases. Recent case law developments reflect a reaction of judges to many of the same issues and changes in commercial practice that motivated the recommendations in the Commission Report. The Report recommends that the rights of secured creditors in chapter 11 be constrained in various ways, but also that certain rights, such as the ultimate right of secured creditors to the going concern value of their collateral in a section 363 sale or under a reorganization plan, be protected, be preserved and given a measure of certainty. Since it appears that an ad hoc rebalancing of secured creditors' rights is in any event in process by the courts, the Report's candid evaluation of those rights and its recommendations, whether one agrees with them or not, at least highlights the arguments on both sides of the issues and frames the debate.

We expect that the Report will be the starting point in a long and vigorous debate regarding the reform of chapter 11. A few recommendations—especially the technical ones—might be picked up and enacted quickly. Larger changes—the recommendations with the most significant impact—are likely to be subject to substantial scrutiny, heavy lobbying efforts and alternative proposals will undoubtedly surface.

While bankruptcy legislation was not high on the political agenda in 1978, when the Bankruptcy Code was passed, by the early 2000s, culminating in the enactment of the 2005 amendments to the Bankruptcy Code, bankruptcy law changes were the subject of intense political debate. Today, with fresh memories of the recent financial crisis and even more intense investor scrutiny, there will no doubt be heightened political interest, and any legislation could bear little resemblance to the recommendations in the Report. Only time will tell.

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