Overview of ABI Commission Report and Recommendation on the Reform of Chapter 11 of the Bankruptcy Code

The last major revision to U.S. business reorganization laws occurred in 1978. Since then, companies’ capital structures have become more complex and rely more heavily on leverage, including secured debt in particular; their asset values are driven less by hard assets and more by services, contracts, intellectual property and other intangible assets; and their business structures and models increasingly are multinational. Moreover, there has been a growing perception that troubled companies are not using Chapter 11, or are waiting too long to use it, thereby undercutting its utility for stakeholders. This perception, in turn, is based on a growing view that Chapter 11 does not work efficiently for many debtors and is prohibitively expensive.

Accordingly, the American Bankruptcy Institute (ABI) established the Commission to Study the Reform of Chapter 11 (the Commission) to comprehensively evaluate U.S. business reorganization laws. The Commission is comprised of 18 Commissioners and four ex officio members, who are among the most prominent Chapter 11 professionals in the United States. They are supported by more than 200 other professionals who served on 13 topical advisory committees. The Commissioners held 17 field hearings to gather testimony while also considering hundreds of other written submissions. The process included perspectives and significant input from representatives of all major stakeholders in Chapter 11 cases.

The culmination of the Commission’s work is its Final Report and Recommendation, released on December 8, 2014 (the Report). The Report, which is approximately 400 pages, addresses numerous aspects of Chapter 11. The key aims of the Commission’s recommendations are to reduce barriers to entry; facilitate certainty and more timely resolution of disputes; enhance exit strategies for debtors; and promote efficiencies and reduce litigation costs by resolving uncertainty and circuit splits under current law. This memorandum provides an overview and analysis of the Commission’s most important recommendations and their ramifications for Chapter 11 debtors and their stakeholders.1 The more notable recommendations are as follows, each of which is discussed in greater detail below:

- Debtor-in-possession (DIP) financing that “rolls up” pre-petition debt must be provided by lenders unaffiliated with holders of the pre-petition debt or must include substantial new credit;

- DIP financing orders cannot impose case milestones within the first 60 days of the case; liens cannot be placed on avoidance actions; and there can be no 506(c) waivers;

- Sales of substantially all of a debtor’s assets cannot occur sooner than 60 days after the petition date unless there is a high likelihood of significant loss of value;

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1 The Report is extensive. While this memorandum summarizes most of the key proposals made in the Report, it does not address all matters, including suggestions regarding small-business debtors, financial institution insolvencies, cross-border issues, and the ongoing debate over venue.
Equity owners can participate in plans even though creditors are not being paid in full so long as the owners contribute new value that is subjected to a market test;

The cramdown interest rate must be based on the market or a modified approach if there is no market, and should not be based on the so-called “prime-plus formula” endorsed by the U.S. Supreme Court in *Till*;

A reorganization plan may be crammed down over objecting creditors even if no class of impaired creditors votes to accept the plan;

Secured creditors can bid the full face amount of their debt on asset sales; that such right may chill bidding does not constitute “cause” to deny a credit bid; and

Junior, out-of-the-money stakeholders may be entitled to “redemption option value” from senior creditors if evidence shows a possible upswing in value.

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1. Cash collateral and DIP financing

a. Valuation information packages

The Commissioners recommend that debtors compile a “valuation information package” (VIP), which must include (i) tax returns for the three years prior to the commencement of the bankruptcy (including all schedules), (ii) annual financial statements (audited if available) for the prior three years (including all footnotes), (iii) the most recent independent appraisals of any of the debtor’s material assets (including any valuations of 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 past two years.

A list of the contents of the VIP should be filed with a motion for authority to use cash collateral or obtain DIP financing and related requests to provide adequate protection. It also may be filed in connection with a Chapter 11 plan filed within 60 days of the petition date. The Commissioners recommend that “any party in interest” be able to request a copy of the VIP to evaluate a pending motion or plan. Unless the court orders otherwise, the debtor should provide the VIP upon request, subject to the recipient’s execution of a confidentiality agreement and, to the extent the VIP contains material non-public information, its agreement to restrict its trading activity in the debtor’s claims and securities.

b. Adequate protection

A debtor must provide adequate protection to a secured creditor to the extent that the debtor’s proposed use of the secured creditor’s cash and other collateral results in a diminution in the value of that collateral. Similarly, a debtor must provide adequate protection to a secured creditor to the extent that any DIP financing facility secured by a lien that is senior to the secured creditor’s lien results in a diminution in the value of the secured creditor’s lien. Adequate protection can take the form of, among other things, periodic cash payments or replacement liens on unencumbered property. A lack of adequate protection constitutes grounds for a secured creditor to obtain modification of the automatic stay to foreclose on its collateral.

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2 11 U.S.C. § 363(e)
4 11 U.S.C. § 361
5 11 U.S.C. § 362(d)(1)
Courts have used a variety of valuation standards in assessing the sufficiency of adequate protection, including liquidation value, going concern value and market value. The Commissioners determined, however, that the less commonly used foreclosure value should be the test. For purposes of the Commissioners’ recommendation, “foreclosure value” is the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor’s collateral under applicable non-bankruptcy law. The foreclosure value should be determined at the time of the request for, or agreement by the parties to provide, adequate protection.

Notwithstanding the foregoing, under the recommendations, a bankruptcy court may consider evidence that the net cash value that a secured creditor would realize upon a sale of its collateral exceeds the foreclosure value (value differential). If the court finds that a value differential exists, then adequate protection can be based on such value differential. Moreover, if a creditor later presents sufficient evidence to warrant relief from the automatic stay, the debtor must sell the collateral pursuant to Section 363 of the Bankruptcy Code unless the creditor elects otherwise. The Commissioners otherwise recommend that the existing split in the court decisions regarding the permissibility of cross-collateralization — the use of post-petition estate property as security for a creditor’s pre-bankruptcy claim — should be permitted, albeit only for the purpose of providing adequate protection and only to the extent of any diminution in the value of the creditor’s collateral as of the petition date.

c. Roll-up provisions

Debtors sometimes obtain DIP financing facilities from their existing lenders that “roll up” the lenders’ pre-petition debt into the post-petition facility, or that pay down pre-petition debt in part or in full with the proceeds of the post-petition facilities. The net effect in either case is to convert the pre-petition debt into post-petition debt. The significance of doing so is that pre-petition debt may be restructured, including upon terms objectionable to the secured creditor, whereas post-petition debt is entitled to priority treatment and must be paid in full as a condition to the debtor’s emergence from Chapter 11. While such provisions obviously can afford significant leverage to lenders, they also can assist in avoiding litigation over the propriety of a DIP facility secured by liens that are senior to the liens of pre-petition lenders. In other words, roll-ups sometimes are used to avoid a priming fight and the related costs of valuation litigation.

The Commissioners noted, however, that such provisions can be abused, and that the greatest opportunity for abuse occurs when a pre-petition lender provides a post-petition facility under which the new money is nominal in comparison to the amount of pre-petition debt that is being rolled up. The Commissioners therefore recommend that such provisions be approved only to the extent that the post-petition facility (i) is provided by lenders who do not directly or indirectly, through their affiliates, hold pre-petition debt affected by the facility, or (ii) 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. In either case, the court must find that the financing is in the best interests of the estate. And as noted below, such provisions may be approved only in final orders, not in interim financing orders.

d. DIP financing under intercreditor agreements

The Commissioners evaluated a relatively common provision found in many intercreditor agreements that precludes a pre-petition junior secured lender from offering post-petition financing to the debtor without the consent of the senior secured lender. The Commissioners noted that such waivers can have a significant negative impact on debtors, who often are not party to the agreement, because
these provisions remove interested and viable sources of financing from the potential pool of post-petition lenders. Therefore, the Commissioners recommend that a junior secured lender subject to this kind of prohibition nonetheless be allowed to provide post-petition financing, free of fear of suits for breach of contract, on two conditions: (i) if the proposed facility does not prime the liens of the pre-petition senior secured lender, and (ii) if the court approves the junior lender’s post-petition facility, the pre-petition senior secured lender must be afforded the right to step in and provide post-petition financing to the debtor on the same terms and subject to the same conditions in lieu of the junior lender.

e. Milestones and other extraordinary provisions

It has become common for post-petition financing agreements and orders to contain milestones, deadlines and other provisions that may dictate or influence the course of a Chapter 11 case or that otherwise affect parties’ rights under the Bankruptcy Code. The Commissioners defined two sets of such provisions. The first set is “milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions.” This includes tasks or conditions that relate in a material or significant way to the debtor’s operations during the Chapter 11 case or to the resolution of the case, including deadlines by which a debtor must conduct an auction, close a sale, or file a disclosure statement and a Chapter 11 plan. The Commissioners recommend that a court not approve any post-petition financing that contains such terms that require the trustee to perform certain tasks or satisfy certain criteria within the first 60 days of the case.

The second set of provisions defined by the Commissioners is “permissible extraordinary financing provisions,” which include (i) milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions, as defined above, (ii) representations regarding the validity or extent of a creditor’s liens, and (iii) if some or all of the proposed post-petition lenders hold pre-petition debt that would be affected by the post-petition facility, a provision that refinances pre-petition debt with proceeds of the post-petition facility that is otherwise permissible, as described above. The Commissioners recommend that no permissible extraordinary financing provisions be approved in interim orders; such provisions may be approved only in final orders.

f. Liens and claims on avoidance actions

Financing orders often provide pre-petition lenders with adequate protection liens on, and/or super-priority claims with respect to, any estate claims for preferences, fraudulent transfers and other avoidance actions. However, such claims often are among the few unencumbered assets of a debtor’s estate. The Commissioners therefore propose that debtors not be permitted to use such actions or recoveries to provide adequate protection to secured creditors. The Commissioners recommend one exception to this rule: where the adequate protection granted to a secured creditor is determined to be insufficient, such creditor should be allowed to receive recoveries from avoidance actions through the creditor’s super-priority claim.

g. Waivers of Sections 506(c) and 552(b)

Section 506(c) of the Bankruptcy Code provides that a debtor may recover the reasonable and necessary costs and expenses of preserving or disposing of a secured creditor’s collateral by surcharging that collateral, i.e., by paying such costs and expenses from the proceeds of the collateral. Sections 552(b) (1) and (2) of the Bankruptcy Code provide that the lien of a secured creditor extends to the proceeds, products, offspring and profits of the creditor’s collateral that are realized post-petition, “except to the extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.”
It has become common in post-petition financing orders for debtors to waive the right to surcharge a lender’s collateral under Section 552(b) and to argue that there are no “equities of the case” under Section 552(b)(1) or (2) warranting a limit on the lender’s lien on proceeds, products, offspring and profits of its collateral. The Commissioners noted, however, that both statutes have gained importance as debtors file Chapter 11 cases with fewer unencumbered assets and limited free cash flow. Thus, the Commissioners propose that Sections 506(c) and 552(b) be modified to prohibit a debtor from waiving any of its rights thereunder.

2. Plans of reorganization

a. Fiduciary duties in the plan context

The Commissioners propose amending the Bankruptcy Code to clarify that the debtor, as distinct from the debtor-in-possession, should not be considered a fiduciary for creditors when acting as plan proponent. The Commissioners’ views were informed by the Bankruptcy Code’s distinction between debtors and debtors-in-possession and the arguably different roles for these two entities. In particular, a debtor-in-possession owes fiduciary duties to the estate and its creditors, whereas a debtor may place its own interests above those of its creditors, consistent with state law governing corporate fiduciaries. The Commissioners determined that potential conflicts of interest could paralyze a debtor-in-possession from acting in this dual role in the plan context.

In the Commissioners’ view, a debtor-in-possession should not have to negotiate a plan for the company and its equity holders with the creditors whose interests the debtor-in-possession represents as a fiduciary of the estate. Accordingly, the Commissioners determined that the debtor should be separated from the debtor-in-possession in the plan context, so that a debtor in this context is required to comply only with its fiduciary duties under applicable state law in negotiating, drafting and seeking confirmation of a Chapter 11 plan. Similarly, a debtor-in-possession’s board of directors, officers, and similar managing persons act as fiduciaries for the debtor in this context, and applicable state law should continue to govern their conduct. The debtor therefore should not be considered a fiduciary for creditors in the plan context.

b. Voting

The Bankruptcy Code requires that creditors be classified into separate classes for purposes of plan treatment and voting based upon, among other things, their relative rights against the debtor. Only creditors with similar claims may be placed in the same class. Under the Bankruptcy Code as currently drafted, creditors within a class must be treated the same, unless a creditor whom a debtor proposes to treat less favorably accepts such treatment. And creditors whose rights have been altered in any way — whose rights are “impaired” — are entitled to vote to accept or reject a plan, unless the creditors are slated to receive no recovery, in which case they are deemed to reject the plan.

A class of creditors accepts a plan if holders of at least one half in number of claims, holding at least two-thirds in dollar amount of claims, votes in favor of the plan, counting only those who actually vote, and not counting any votes that were not cast in good faith. A plan must be accepted by every

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6 11 U.S.C. § 1123(a)(1)
7 11 U.S.C. § 1122(a)
8 11 U.S.C. § 1123(a)(4)
9 11 U.S.C. §§ 1124 and 1126(c)
10 11 U.S.C. § 1126(c)
class of impaired creditors as a condition to confirmation of the plan.11 Alternatively, a plan may be confirmed over the rejection of one or more classes, so long as at least one impaired class of claims votes to accept the plan, not including the votes of any insiders.12 In such event, however, the treatment of the rejecting classes must be fair and equitable as defined by the Bankruptcy Code.13

The Commissioners determined that the foregoing statutory scheme has been the source of significant gamesmanship and litigation, much of it focused on the requirement that at least one impaired class of creditors vote to accept the plan. Indeed, numerous courts have considered whether a proposed creditor classification scheme is proper, or merely designed to gerrymander a single favorable vote on the plan.14 Other courts have considered whether a “technical” or “artificial” impairment of a class entitles the class to vote,15 and still others have considered whether a class may be “deemed” to accept a plan if no creditors in the class vote at all.16 Moreover, managers of distressed funds may have an incentive to acquire and hold claims in separate funds in an effort to control the “numerosity” requirement in a particular class.17 And courts recently have considered the circumstances under which competitors or other creditors have cast rejecting votes with an ulterior purpose and hence, whether such votes should be disqualified.18

The Commissioners recommend significant changes to these and other voting requirements in order to resolve or mitigate the foregoing issues. First, the Commissioners propose eliminating the requirement of at least one accepting impaired class of creditors. The Commissioners determined that while the requirement may serve a potential gating role by ensuring that some impaired creditors support confirmation of a plan, it has created impediments to confirmation and creditor hold-up value in many Chapter 11 cases. The Commissioners further determined that the potential delay, cost, gamesmanship and value destruction as a result of the requirement significantly outweighed its presumptive gating role. The Commissioners therefore propose eliminating the requirement in its entirety. To counterbalance this new proposed rule, however, the Commissioners propose to prohibit a plan from providing for “deemed acceptance” if an impaired class of claims fails to garner any votes accepting or rejecting the plan.

Second, the Commissioners propose replacing the numerosity requirement with a “one creditor, one vote” concept. Accordingly, class acceptance will require acceptance by a majority in number of creditors as opposed to number of claims. The Commissioners’ views were informed by anecdotal evidence that the numerosity requirement served, at best, a nominal role in determining class support for a Chapter 11 plan and had become subject to significant gamesmanship by debtors and creditors alike. The Commissioners therefore chose to develop a one creditor, one vote rule whereby affiliated

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13 11 U.S.C. § 1129(b)
15 See W. Real Estate Equities, LLC v. Vill. at Camp Bowie I, LP (In re Vill. at Camp Bowie I, LP), 710 F.3d 239 (5th Cir. 2013) (artificial impairment sufficient for voting purposes); Windsor on the River Assocs., Ltd. v. Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.), 7 F.3d 127 (9th Cir. 1993) (no voting rights for artificially impaired claims).
16 See Heins v. Ruti-Sweetwater, Inc. (In re Ruti-Sweetwater, Inc.), 836 F.2d 1263 (10th Cir. 1988) (non-voting class deemed to accept plan); Bell Road Inv. Co. v. M. Long Arabians (In re M. Long Arabians), 103 B.R. 211 (B.A.P. 9th Cir. 1989) (failure to vote does not constitute acceptance).
17 See Figter Ltd. v. Teachers Ins. & Annuity Ass’n of Am. (In re Figter Ltd.), 118 F.3d 635 (9th Cir. 1997) (secured creditor that purchased majority of unsecured claims in only impaired class was entitled to vote each such claim against confirmation).
entities under common investment management will be treated as a single creditor for voting purposes, while creditors holding claims in different capacities (e.g., as an indenture trustee and as an individual creditor) will be able to vote once in each capacity.

Third, the Commissioners propose providing stronger guidance to courts in addressing conflicts of interest that may influence a creditor’s vote on a Chapter 11 plan. The Commissioners recognized that a creditor should be able to vote in its own self-interest and that the mere existence of a potential conflict should not warrant disqualification. Nonetheless, the Commissioners determined that at some point, self-interested conduct by a creditor holding interests adverse to the debtor or other creditors in the class should result in the creditor losing its voting rights. The Commissioners therefore propose to permit courts to consider not only whether the creditor’s vote was cast in bad faith, but also whether it was “manifestly adverse” to the interests of the general creditors in the class. In the Commissioners’ view, this hybrid standard would maintain creditor autonomy while providing courts with the necessary tools to protect the estate and its creditors.

Finally, the Commissioners propose to resolve a split among courts as to the enforceability of pre-petition voting waivers or assignments, which are often found in intercreditor agreements, whereby junior creditors agree to vote in accordance with the wishes of more senior creditors. The Commissioners’ inquiry focused largely on two policy considerations: respecting the private contract rights of non-debtor parties and fostering the underlying goals of Chapter 11. Ultimately, the Commissioners noted that they were uncomfortable with non-debtor parties being able to alter the rights of the debtor and other stakeholders in the case. The Commissioners determined the key element of subordination agreements — preserving the payment priority among creditors — would not be affected by prohibiting assignments or waivers of voting rights. Accordingly, the Commissioners propose that subordinated creditors retain the right to vote on a plan, notwithstanding the pre-petition assignment or waiver of voting rights in favor of senior creditors.

c. The absolute priority rule

i. New value plans

The “absolute priority rule” provides that stakeholders in a debtor must receive consideration under a Chapter 11 plan on account of their claims and interests in strict priority. Accordingly, a plan must make provision for payment in full of more senior creditors as a condition to more junior creditors or equity holders receiving or retaining any consideration under the plan on account of their junior claims or equity interests. The Commissioners noted, however, that existing equity holders of a bankrupt entity often are motivated to help reorganize the entity, and hence, may be a constructive source of funding its reorganization. Indeed, many courts have recognized a so-called “new value” exception or corollary to the absolute priority rule, whereby existing equity holders can participate in a reorganization, even if more senior stakeholders are not paid in full, if existing equity holders provide economic value to the reorganization effort.19

However, courts historically have been split on whether the Bankruptcy Code codified the new value exception and, if so, what the contours of the exception are. The Supreme Court had the opportunity to clarify the issue in Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership.20 In rendering its decision in that case, the Court assumed, without deciding, that

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20 526 U.S. 434 (1999)
the new value exception existed. Significantly, the Court held that existing equity holders could not be afforded the exclusive opportunity to provide new value, suggesting instead that any such opportunity must be subjected to a market test. Lower courts and commentators subsequently have suggested that if a debtor proposes a new value plan, the debtor’s exclusive period for proposing a plan should be terminated to allow other stakeholders to test the parameters of the debtor’s plan.  

The Commissioners determined that clarification of the role of existing equity would benefit the Chapter 11 reorganization process. The Commissioners therefore propose to codify the new value corollary as an express exception to the absolute priority rule. Specifically, the Commissioners propose that a pre-petition interest holder (including an insider) be permitted to retain or purchase an interest in the reorganized debtor without violating the absolute priority rule if such interest holder (a) contributes new money or money’s worth, in an amount proportionate to the equity received or retained by the pre-petition interest holder, and (b) that contribution is subject to a “reasonable” market test. The Commissioners do not define the parameters of the proposed “reasonable” market test. Rather, they recommend that courts make this determination based on the facts and circumstances of each particular case.

**ii. “Gifting” of plan consideration**

Another practice has arisen in recent years whereby parties sometimes work around the absolute priority rule with so-called “gifting” plans. Under a gifting plan, creditors of senior priority “gift” a portion of their plan recovery to a class of lower priority not otherwise entitled to a recovery and, in doing so, “skip” over an intervening class that is not being paid in full. As a result, the lower priority class receives consideration even though the intervening class is not being paid in full. Courts that have approved this approach reason that the absolute priority rule is not being violated because the class of lower priority is not receiving consideration “under the plan”; rather, it is receiving a “gift” from the senior class out of the senior class’ recovery. Other courts, including the Second and Third circuits, have limited or rejected the gifting doctrine as an improper end-run around the absolute priority rule. The Commissioners weighed the benefits of using gifting to facilitate confirmation against concerns regarding the ability of senior creditors to unduly influence plan negotiations by making distributions outside of the Bankruptcy Code’s priority scheme. Ultimately, the Commissioners determined that on balance, the potential abuses outweighed the benefits. Accordingly, the Commissioners recommend that gifting be prohibited in the Chapter 11 context.

**iii. Cramdown interest rates**

The Bankruptcy Code permits confirmation of a plan over the objection of a secured creditor if the secured creditor retains its lien on its collateral and receives deferred cash payments having a present value equal to the creditor’s allowed secured claim as of the plan effective date. Though seemingly straightforward, courts have differed in their interpretations of this section. The primary issue is the appropriate discount rate to be applied in calculating the present value of the deferred cash payments to be provided to the secured creditor. In Till v. SCS Credit Corp., a plurality of the Supreme Court held that the appropriate discount rate for purposes of a Chapter 13 consumer plan should be determined

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23 See Dish Network Corp. v. DBSD N. Am., Inc. (In re DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011); In re Armstrong World. Indus., Inc., 432 F.3d 507 (3d Cir. 2005).


by using the risk-free rate of interest — in that case, the prime rate — and adjusting that rate upward by between 100 to 300 basis points to account for the particular risk of default, the nature and quality of the collateral, and the duration and feasibility of the plan.

Some courts have applied the “Till formula” (or “prime-plus formula”) to the Chapter 11 context. By contrast, some commentators and courts have criticized the use of the Till formula in Chapter 11 cases, noting that there are significant differences between the debt instruments and assets of a Chapter 11 debtor and those of a Chapter 13 debtor, and that an efficient market is more readily ascertainable in the Chapter 11 context. Accordingly, some courts have adopted different, more market-oriented approaches to determine the appropriate discount rate, including the “coerced loan approach,” the “cost of funds approach,” and the “presumptive contract rate approach.” Given these disparate approaches, including uncertainty over whether “prime-plus formula” should apply in Chapter 11 cases, the Commissioners determined that greater clarity was needed regarding the standard to be applied for determining the appropriate discount rate.

In short, the Commissioners propose to amend Chapter 11 to adopt a market-oriented approach and to reject the Till formula. Specifically, the Commissioners propose that, in determining the discount rate, a court consider the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity, taking into account the size and creditworthiness of the debtor, the nature and condition of the collateral, and other factors. If the court determines that an efficient market does not exist, the Commissioners propose that the court use an appropriate risk-adjusted rate that reflects the actual risk posed with respect to the reorganized debtor, considering factors such as the debtor’s industry, projections, leverage, revised capital structure and plan obligations. The Commissioners believe that the proposed market approach more faithfully provides the secured creditor with the value of its allowed secured claim on the effective date, even if that amount is paid over an extended period.

iv. Plan valuation matters: reorganization value and redemption option value

As reflected in the Commissioners’ suggested codification of the new value exception to the absolute priority rule, the Commissioners determined that while the rule is an important creditor protection, it has also proven to be inflexible and often a barrier to a successful reorganization. According to the Commissioners, the rule can also result in allocations of value among creditors in an arguably random manner depending on the timing of the value realization event, i.e., plan confirmation. Junior creditors and interest holders therefore may lose their rights and receive no value solely because of the timing of the valuation of the enterprise. The Commissioners’ views were informed in part by statistical evidence suggesting that most economic cycles and industry events resolve themselves within three to five years.

The Commissioners therefore chose to develop a framework for adjustment to the absolute priority rule that avoids cutting off alternative distributional possibilities based on the fortuity of timing of the reorganization and attempts to avoid or minimize the often wasteful and time-consuming litigation that occurs in many cases over reorganization value. The Commissioners’ framework includes two new concepts: “reorganization value” and “redemption option value.” With respect to the former, the Commissioners propose that senior creditors be entitled to receive, with respect to their secured

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28 See e.g., In re MPM Silicones, LLC, 2014 WL 4436335, at 24-32 (Bankr. S.D.N.Y. Sept. 9, 2014) (describing the various approaches that have been employed by courts and adopting the Till formula).
claims, distributions having a value equal to the “reorganization value” attributable to their collateral, which is defined as the enterprise value attributable to the reorganized business entity, plus the net realizable value of any collateral assets not included in enterprise value and that will be disposed of under the plan.

The reorganization value concept, however, is subject to the redemption option value concept. In particular, a class of creditors immediately junior to a senior class that benefits from preserving the debtor’s value as a going concern — the “immediately junior class” — should receive an allocation of value — the “redemption option value” — that recognizes the possibility that the ongoing firm may have generated a recovery for the immediately junior class had the firm been valued at a later date. The immediately junior class typically will be the class immediately below the fulcrum security class, i.e., it likely will be the class that would first derive material benefit from future increases in reorganization value after payment in full of all senior classes.

The “redemption option value” is defined as the value of a hypothetical option to purchase the entire firm with (i) an exercise price equal to the “redemption price” — the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any non-default interest and allowable fees and expenses accruing through the hypothetical date of exercise of the option, as though the claims remained outstanding on the date of exercise of the option — and (ii) a duration equal to the “redemption period” — a period commencing on the plan effective date and ending on the third anniversary of the petition date.

The Commissioners expect that any redemption option value would not be in the form of an actual option, but would rather be in the form of cash, debt, stock, warrants or other consideration, with the form of such consideration being at the sole election of the senior class being required to give up such value. The option value would be determined based on the evidence presented by the parties, but it should be based on generally accepted, market-based valuation models, including the Black-Scholes option pricing model. The Report includes two examples of calculation of redemption option value. In the first example, the senior class is entitled to the entire value of the firm. However, the estimated reorganization value will afford a recovery to the senior class of only 50 percent. The senior class in this example therefore is vastly underwater. Assuming a volatility rate of 15 percent, a risk-free rate of 2.23 percent, and a redemption period of two years (the plan is confirmed one year into the case), the redemption option value likely is zero. In the second example, all assumptions remain the same, except that the estimated recovery to the senior class is 90 percent. In this example, where the value is much more “cuspy,” the redemption option value is approximately 5 percent of the reorganization value.

In order to implement the foregoing concepts, the Commissioners propose amending the cramdown rules to provide that a plan may be crammed down over a senior class — even if the senior class is not paid in full as prescribed by the absolute priority rule — if the plan’s deviation from the rule is solely on account of the distribution to the immediately junior class of the redemption option value. Similarly, a plan may be crammed down over the immediately junior class so long as it receives not less than the redemption option value attributable to such class. Significantly, in a further effort to minimize the expense of valuation litigation, if an immediately junior class challenges the reorganization value used to determine the class’ entitlement to the redemption option value, the plan should be confirmed if the court finds that the reorganization value “was not proposed in bad faith.” This standard likely will be a relatively easy one for a debtor to satisfy in contested valuation litigation.

Finally, the Commissioners acknowledge that the foregoing principles are unique, new, complex, and will require further development as they are applied in more complicated situations, e.g., where a senior class is entitled to less than all of a firm’s enterprise value; where contractual or structural subordination
rather than a lien results in an immediately junior class; where there are multiple senior classes, and not all such classes are receiving distributions in the form of interests in the residual value of the firm; and where only part of an immediately junior class challenges reorganization value under a plan.

d. Releases and exculpation

Reorganization plans frequently contain provisions that release or afford a limited immunity to certain non-debtors who contribute to a debtor’s reorganization efforts. In particular, plans sometimes provide that a creditor’s vote on a plan constitutes a consensual release of any claims such creditors may have against directors, officers, affiliates and other parties. Plans also sometimes provide that such third-party releases will be provided regardless of creditor consent. Finally, plans typically contain exculpation clauses that limit the liability for estate and other professionals and their clients for certain acts or omissions in connection with the debtor’s case, including plan formulation process.

There have long been significant splits in the case law regarding the propriety of such provisions and the standards for approving them. Except for specific types of releases explicitly authorized in cases involving asbestos debtors, the Bankruptcy Code does not explicitly authorize third-party releases or exculpation provisions. Accordingly, some courts have held that such release and exculpation provisions are inconsistent with the Bankruptcy Code, including in particular Section 524(e), which provides that the debtor’s discharge does not impact the liability of any other entity on the discharged debt. Other courts have been willing to approve such provisions but have applied varying standards in determining whether to approve the provisions. Finally, courts have differed on the appropriate scope of exculpation clauses.

In light of the foregoing, the Commissioners determined that greater consistency was needed with respect to the treatment of third-party release and exculpation provisions. As an initial matter, the Commissioners determined that a blanket prohibition on third-party releases and exculpations was inadvisable, observing that there are several instances in which the inclusion of third-party releases facilitated confirmable plans and, thereby, benefited all stakeholders. Nonetheless, the Commissioners also acknowledged that such provisions could fundamentally alter the rights of creditors and that these provisions would not always be appropriate.

Accordingly, the Commissioners propose, first, that plan provisions providing for consensual third-party releases be enforceable. Second, the Commissioners propose that non-consensual, third-party releases also be enforceable, subject to a bankruptcy court considering and balancing the following factors in determining the propriety of such releases: (i) the identity of interests between the debtor and the third party (including indemnity relationships and the impact on the estate of allowing claims against the third party), (ii) any value contributed by the third party, (iii) the necessity of the release to facilitate the plan or the debtor’s reorganization, (iv) creditor support for the plan, and (v) the payments and protections otherwise available to creditors affected by the release. The Commissioners

29 11 U.S.C. § 524(g)
30 See e.g., Resorts Int’l, Inc. v. Lowenschuss (In re Lowenschuss), 67 F.3d 1394, 1401-02 (9th Cir. 1995).
32 Compare Upstream Energy Servs. v. Enron Corp. (In re Enron Corp.), 326 B.R. 497, 504-05 (S.D.N.Y. 2005) (exculpation provision was limited to exculpating only negligent conduct occurring after the commencement of the bankruptcy), with Bank of N.Y. Trust Co. v. Official Unsecured Creditors’ Comm. (In re Pac. Lumber Co.), 584 F.3d 229, 252-53 (5th Cir. 2009) (finding that appeal was not equitably moot and refusing to approve a provision that exculpated plan proponents, the reorganized debtors, and the unsecured creditors’ committee from liability for negligent conduct relating to the proposal, implementation and administration of the plan of reorganization, except as to the creditors’ committee under Section 1103(c)).
propose that courts give significant weight to the last of these factors. Significantly, these factors do not include a separate requirement (adopted by some courts) that the circumstances of the case be unique or unusual for the non-consensual releases to be approved.\textsuperscript{33} In this regard, the Commissioners believe that the foregoing factors adequately capture the careful review required of non-consensual third-party releases.

Finally, with respect to exculpation provisions, the Commissioners propose that the Bankruptcy Code be amended to permit appropriate plan exculpation provisions. The Commissioners propose that permissible exculpation provisions cover parties participating in a Chapter 11 case and identified in the plan (including professionals), subject to customary exclusions consistent with public policy (e.g., fraud, willful misconduct and gross negligence), and provide for exculpation with respect to acts or omissions during the case and prior to the effective date of the plan (including in connection with negotiating, drafting and soliciting the plan).

e. Other plan matters

i. Approval of settlements

While the Bankruptcy Code embodies a policy that favors settlements, neither the Code nor the Bankruptcy Rules specify any explicit standard for court approval of same. Given the general policy, courts have generally approved settlements that fall within the lowest point in the range of reasonableness but have employed different factors in determining whether a particular settlement falls within that range. However, the Commissioners believe that the lowest point of reasonableness standard does not allow for sufficient scrutiny of settlements or their impact upon the estate. Accordingly, the Commissioners propose that a settlement or compromise be approved only if the court finds that the proposed settlement or compromise is reasonable and in the best interest of the estate.

This new standard represents an intermediate standard that requires greater scrutiny than the lowest point of reasonable standard, while falling short of the more exacting standard under which a court must find that the settlement is fair and equitable, which was applied by the Supreme Court in \textit{TMT Trailer Ferry}.\textsuperscript{34} The Commissioners further propose that this new standard be applied whether the settlements or compromises in question are proposed as part of a plan or not (excluding customary resolution of claims or interests against the estate).

ii. Preemption

Section 1123(a)(5) of the Bankruptcy Code provides that, notwithstanding any otherwise applicable non-bankruptcy law, a plan shall provide adequate means for the plan’s implementation. The legislative history makes clear that Section 1123(a)(5) was intended to permit actions to be taken under a confirmed plan without a resolution by a debtor’s board of directors, notwithstanding any otherwise applicable non-bankruptcy law. Nonetheless, and despite this legislative history, certain courts have narrowly read Section 1123(a)(5) and limited its pre-emptive effect to non-bankruptcy laws relating to financial condition. To reflect the broader intended scope, the Commissioners propose clarifying that a confirmation order governs the implementation of all transactions contemplated by the plan in accordance with Section 1123(a)(5) and pre-empts any applicable non-bankruptcy law. This pre-emption would not, however, relieve the directors, officers, or similar managing persons of the debtor of their fiduciary duties under applicable state entity governance law in implementing the plan transactions.

\textsuperscript{33} See \textit{e.g.}, \textit{In re Metromedia Fiber Network, Inc.}, 416 F.3d 136, 142-43 (2d Cir. 2005).

iii. Scope of the plan discharge

Section 1141(c) of the Bankruptcy Code provides that property dealt with by a reorganization plan is free and clear of all claims and interests of creditors, equity holders and general partners (subject to certain exceptions from discharge and except as otherwise specified in the plan or confirmation order). Nonetheless, some courts have limited the application of this provision, particularly in the successor liability context. The Commissioners propose to clarify the scope of Section 1141(c) so that property addressed by the plan is free and clear of claims and interests to the same extent as that which the Commissioners are proposing for sales under Section 363 of the Bankruptcy Code, described further below, including successor liability claims.

3. Asset sales

a. Standard of review for asset sales, other than sales of substantially all assets

Section 363(b) of the Bankruptcy Code provides that a debtor may use, sell or lease property outside of the ordinary course of business following notice and a hearing, but does not specify a standard of review. In considering nonordinary course sales or uses of property, the Commissioners noted that, in many instances, the decisions of a debtor’s directors are protected under state law by the business judgment rule, which presumes that in making a business decision, the directors acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the debtor. Nonetheless, the Commissioners also observed that courts often applied different standards for reviewing proposed sales or transactions under Section 363(b), with some courts undertaking a very deferential review of the debtor’s business judgment, and other courts scrutinizing the transaction more closely to review both the process implemented by the debtor leading up to the transaction and the reasonableness of the debtor’s business judgment (known as the “enhanced” or “intermediate” business judgment standard).

The Commissioners determined that it would be advisable to clarify the standards of review to be applied by courts in evaluating nonordinary course sales of a debtor’s assets, but distinguished between nonordinary course sales involving only some of a debtor’s assets and nonordinary course sales involving all or substantially all of a debtor’s assets (Section 363x sales), which raise special issues warranting a separate standard of review. The Commissioners ultimately determined that an intermediate standard of review should be applied to nonordinary course sales or uses of assets that do not implicate all or substantially all of the debtor’s assets. In this regard, the Commissioners propose that such sales or uses be approved only if the court finds that the debtor has exercised reasonable business judgment. In making this determination, the court should consider both the process pursued by the debtor and the reasonableness of the business decision.

b. Sales of substantially all assets

As noted, the Commissioners further determined that Section 363x sales raise distinct issues warranting a separate standard of review. The Commissioners noted that Section 363x sales are value realization events that are, in some ways, similar to a debtor’s plan. In this regard, Section 363x sales transform estates from assets having fluctuating values to fixed sums of money or securities, thereby altering estate values in a positive or negative direction depending on the timing of the sales, the marketing of the assets, the competitive nature of the auctions, and the sale and restructuring alternatives explored by the debtors in the lead-up to the sales. A key concern was the timing of such sales,
which the Commissioners believed should be sufficient to allow for a methodical process in which debtors could identify (and creditors could confirm) that the sales both provided the best and highest offer for the assets and constituted the best restructuring alternative for the debtors and stakeholders. Moreover, the Commissioners believed that the standard applicable to Section 363x sales should appropriately protect creditors and interest holders, who do not have the right to vote on the sale (unlike a plan) but are often impaired by, and receive nominal (if any) consideration from, the sale.

Accordingly, the Commissioners propose that a debtor be precluded from conducting an auction for, or receiving final approval of, a Section 363x sale before 60 days after the petition date or the order for relief (whichever is later) unless the debtor or a party in interest demonstrates a high likelihood that the value of the debtor’s assets will decrease significantly during the period. Moreover, the Commissioners propose that such a sale be subject to requirements that are similar to the requirements for confirming a plan of reorganization under Section 1129 of the Bankruptcy Code. In this regard, the Commissioners propose that a Section 363x sale only be approved if the court finds that the sale is in the best interests of the estate and satisfies the following requirements: (i) the sale complies with applicable provisions of the Bankruptcy Code, (ii) the proponent of the sale complies with applicable provisions of the Bankruptcy Code, (iii) the sale has been proposed in good faith and not by any means forbidden by law, (iv) any payment to be made by the debtor or the acquirer in connection with the sale or the case has been approved by the bankruptcy court as reasonable (or is subject to such approval), (v) the debtor reserves sufficient proceeds from the sale to satisfy in full allowed administrative and certain priority claims, and (vi) the debtor has provided adequate notice and opportunity to be heard to creditors and equity holders.

Finally, the Commissioners considered whether it would be appropriate to require shareholder approval for Section 363 sales, including Section 363x sales. In this regard, the Commissioners noted that bankruptcy courts have generally approved Section 363 sales without requiring shareholder approval even though such approval would be required under state law outside of bankruptcy. The Commissioners determined that requiring shareholder approval would cause undue delay, and noted that equity holders are often “out-of-the-money” and have the separate right to object to a sale in any event. The Commissioners therefore propose to amend the Bankruptcy Code to clarify the ability of a debtor’s board of directors to pursue transactions under Section 363 without a vote of the debtor’s equity holders.

c. Sales free and clear of liens, claims and interests

Section 363(f) of the Bankruptcy Code permits a debtor to sell property of the estate free and clear of any interest in such property of an entity other than the estate. Such a “free and clear” sale may only be approved under Section 363(f) if: (i) applicable nonbankruptcy law permits a free and clear sale, (ii) the non-estate entity having the interest consents to the sale, (iii) the interest is a lien and the sale price for the property exceeds the aggregate value of all liens on the property, (iv) the interest is in bona fide dispute, or (v) the non-estate entity could be compelled in a legal or equitable proceeding to accept a money judgment in satisfaction of its interest.

The Bankruptcy Code does not define “interest” and provides little guidance on the term’s meaning, although the legislative history indicates that a lien is an interest in property.\textsuperscript{36} Moreover, courts have adopted differing approaches to the meaning of the term. The first approach construes “interest” narrowly, limiting

its application to liens, security interests, mortgages, and money judgments. The second approach is more expansive and captures not only those interests encompassed within the first approach but also claims against the debtor or the property sold, including successor liability claims, discrimination claims, personal injury claims and other “claims” as defined by the Bankruptcy Code. Courts have also taken different approaches in interpreting the separate requirement that the sale price for the property exceed the aggregate value of all liens on the property. In this regard, some courts have held that the sale price must exceed the face value of all secured claims, while other courts have held that the sale price must only exceed the economic value of the lienholders’ allowed secured claims.

The Commissioners analyzed Section 363(f) and the splits in the case law, finding that uniformity in application and an expansive interpretation of this section were more likely to foster greater competition for a debtor’s assets and, ultimately, generate greater value. The Commissioners therefore propose that the debtor be permitted to sell assets free and clear of all interests in a debtor’s assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution, and that the debtor also be permitted to sell assets free and clear of all claims related to the assets if the debtor has complied with the requirements of a Section 363x sale (whether or not the sale itself involves all or substantially all of a debtor’s assets). The Commissioners propose that the claims subject to a free and clear sale include successor liability claims (in both contract and tort) and civil rights liabilities (all except to the extent specifically excluded).

The Commissioners further propose that the court not approve sales that are free and clear of the following types of claims or interests: (i) easements, covenants, use restrictions, usufructs, equitable servitudes and environmental obligations that run with the land under applicable non-bankruptcy law, (ii) successor liability for purposes of federal labor law, (iii) partial, competing or disputed ownership interests (except as currently provided in the Bankruptcy Code), and (iv) government enforcement rights that are within the government’s police or regulatory powers and are for post-sale costs of enforcement.

Furthermore, the Commissioners propose that a debtor only be allowed to sell assets free and clear of executory contracts, unexpired leases and collective bargaining agreements to the extent that such contracts, leases or agreements are rejected under the other, applicable provisions of the Bankruptcy Code. Finally, the Commissioners propose that Section 363(f) be amended to provide that the debtor may sell assets free and clear of interests without the consent of the lienholder, regardless of whether the assets generate value in excess of the aggregate value of the liens, so long as the liens attach to the sale proceeds or the lienholder receives another appropriate form of adequate protection.

d. Credit bidding

Section 363(k) of the Bankruptcy Code permits a secured creditor to credit bid the amount of its claim when its collateral is proposed to be sold, except to the extent that the court “for cause” orders otherwise. Courts have found cause to limit the right to credit bid where the amount of the secured creditor’s claim is disputed. Courts have also recently found cause to limit a secured creditor’s right to credit bid where the creditor has engaged in an overly zealous “loan-to-own” strategy discouraging competitive bidding, and where allowing the creditor the right to credit bid would freeze out all

37 See e.g., Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.), 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987).
38 See e.g., In re Trans World Airlines, Inc., 322 F.3d 283, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of Section 363(f) to include claims).
competitive bidding. The Commissioners considered credit bidding under Section 363(k) in light of this recent case law, which arguably expands “cause” to limit credit bidding.

The Commissioners noted that any credit bidding could chill the auction process and that credit bidding played a fundamental role under state law and Section 363(k). The Commissioners, therefore, found that the potential to chill bidding should not, itself, be deemed cause to limit credit bidding. Accordingly, the Commissioners propose, consistent with current law, that a secured creditor should be permitted to credit bid up to the full face amount of its claim when its collateral is proposed to be sold, unless the court orders otherwise for cause. For purposes of this principle, the Commissioners further propose that the potential chilling effect of credit bidding should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the procedures to govern the sale process.

e. Sale valuation matters: reorganization value and redemption option value

As noted above, the Commissioners determined that the absolute priority rule in the plan context can result in allocations of value among creditors in an arguably random manner depending on the timing of the value realization event, i.e., plan confirmation. Junior creditors and interest holders therefore may lose their rights and receive no value solely because of the timing of the valuation of the enterprise. Accordingly, as described further above, the Commissioners propose changes to the absolute priority rule to incorporate a new, “redemption option value” concept. Significantly, the Commissioners propose a similar concept applicable in the context of sales of substantially all of a debtor’s assets.

As in the context of the absolute priority rule, the Commissioners’ new framework for asset sales includes two new concepts: “reorganization value” and “redemption option value.” With respect to the former, the Commissioners propose that senior creditors are entitled to receive, with respect to their secured claims, distributions from an asset sale having a value equal to the “reorganization value” attributable to their collateral, which is defined in the sale context as the net sale price for the enterprise, plus the net realizable value of any assets not included in the sale and that will be disposed of under a plan or pursuant to a later sale.

The reorganization value concept, however, is subject to the redemption option value concept. This concept is defined the same way in both the plan context and the sale context and also is designed to work the same way in each scenario, i.e., a class of creditors immediately junior to a senior class that benefits from preserving the debtor’s value via a going concern sale — the “immediately junior class” — should receive an allocation of value — the redemption option value — to recognize the possibility that the ongoing firm may have generated a recovery for the immediately junior class had the firm been sold or valued at a later date. Significantly, however, the immediately junior class may receive any redemption option value in the sale context only if it does not object to the proposed sale. If the class objects, the class loses any entitlement to any such value. This approach clearly is designed to reduce the prospects of expensive valuation and other litigation challenging the sale process.

f. Reopening sales

The purpose of a sale and of the court-approved auction procedures that commonly accompany a sale is to generate maximum value for the estate. Issues can, therefore, arise if there is a perception that the auction or sale has not maximized value and a party seeks to second-guess the auction results or

the sale order by seeking judicial relief. In considering such situations, the Commissioners acknowledged that allowing a court to reopen the auction or reconsider the sale order might result in increased value to the estate. Nonetheless, the Commissioners believed that endorsing this type of relief could encourage gamesmanship and prevent robust auctions in the first instance because bidders could not count on their ability to close the sale even if all relevant procedures were complied with.

Accordingly, the Commissioners propose that a court not be permitted to reconsider a non-ordinary course transaction after the order approving the transaction has been entered unless the court finds extraordinary circumstances or material procedural impediments (such as lack of adequate notice or an improperly conducted sale process) to the auction process that may have materially impacted the sale results. For purposes of the proposal, the potential that a new or continued auction could result in additional value is not itself an extraordinary circumstance.

4. Safe harbor agreements

As a general matter, a non-debtor party to an executory contract with a debtor may not terminate the contract solely on account of the debtor’s financial condition or the filing of a bankruptcy petition. This rule, however, does not apply to certain categories of statutorily-defined financial contracts, including swap agreements, repurchase agreements, securities contracts, commodities contracts and forward contracts. Accordingly, most nondebtor parties to such contracts are free to terminate such contracts and exercise any and all related remedies, including foreclosing on and selling collateral, notwithstanding the automatic stay. Moreover, many pre-petition transfers made in connection with such contracts are immune from avoidance and recovery as preferences or fraudulent conveyances. These so-called “safe harbors” have been a feature of the Bankruptcy Code for many years, though they were significantly expanded in 2005.

The Commissioners propose narrowing the scope of some safe harbors and related provisions, including as a result of certain court decisions interpreting the relevant statutes. The Commissioners’ recommendations stem in part from a concern that the safe harbors have been extended well beyond their intended purpose of promoting market liquidity and stability to now protect counterparties with questionable ties to the securities and commodities markets. As a result, many transactions arguably not within the original legislative intent of the safe harbors have become insulated from challenge, resulting in the evisceration of some of the most important protections and policies of the Bankruptcy Code.

a. Section 546(e)

Section 546(e) of the Bankruptcy Code provides that a trustee may not avoid a pre-petition transfer that is a settlement payment made by, to or for the benefit of certain financial participants, or that is a transfer made by, to or for the benefit of such parties in connection with a securities contract. Courts have applied the 546(e) safe harbor to a broad array of transactions, including leveraged buyouts where the consideration was transferred to private equity owners which arguably have no impact on the securities market. The Commissioners noted that absent Section 546(e), such payments would otherwise be subject to avoidance as fraudulent transfers for the benefit of the debtor’s estate. In order to bring Section 546(e) more in line with the original purpose of the legislation, the Commissioners

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42 11 U.S.C. § 365(e)
43 11 U.S.C. §§ 362(b)(6), (b)(7), (b)(17) and (b)(27); 555, 556 and 559-561
44 11 U.S.C. §§ 546(e), (f), (g) and (j)
recommended removing the protection from avoidance actions currently provided to beneficial owners of privately issued securities in connection with leveraged buyouts.

b. Repurchase agreements

Prior to 2005, protected repurchase agreements included only those involving the financing of government-backed securities. In 2005, however, Congress significantly expanded the scope of the definition of repurchase agreements to include those that finance mortgages and mortgage-related securities. The Commissioners questioned whether such expansion furthered the underlying policies of the safe harbors. In particular, some of the Commissioners noted that mortgage warehouse arrangements arguably qualify for protection under the current safe harbors but do not present the same market risks posed by true repurchase agreements. Accordingly, the Commissioners propose to revert back to the pre-2005 definition of repurchase agreements as a means to foster financial stability, reduce interconnectedness and exclude disguised financing arrangements.

c. Physical supply contracts

Recent Fourth Circuit and Fifth Circuit decisions have extended the safe harbor protections to suppliers of commodities that, in the Commissioners’ view, appeared to constitute nothing more than physical supply agreements between private parties, unconnected to the securities markets. The Commissioners believe that the purposes of the safe harbors are not furthered by such a broad interpretation. They therefore propose to amend the Bankruptcy Code to prevent nondealer counterparties to physical supply contracts (e.g., contracts for the supply of natural gas and electricity) from benefiting from the safe harbor protections.

d. Damages

Lastly, the Commissioners propose two amendments designed to resolve ambiguities in existing case law regarding damages under qualified financial contracts. First, the Commissioners propose to amend the Bankruptcy Code to provide that so-called “walkaway clauses” in qualified financial contracts be unenforceable. Walkaway clauses are provisions that, upon termination, liquidation or acceleration of a contract by the nondefaulting party, eliminate the benefits of the contract for the defaulting counterparty even if the contract is in the money for such defaulting counterparty. This change brings the Bankruptcy Code in line with the treatment of such clauses in connection with the insolvencies of federally insured depository institutions under the Federal Deposit Insurance Act.

Second, the Commissioners recommend amending Section 562, which provides for the calculation of damages when a qualified financial contract is rejected by a debtor, or liquidated, terminated or accelerated by a nondebtor. Section 562 provides that if no commercially reasonable determinants of value exist on the earlier of the date of rejection or the date of liquidation, termination or acceleration, damages should be measured as soon as commercially reasonable determinants of value are available. Accordingly, the meaning of “commercially reasonable determinants of value” plays a key role in determining damages. In evaluating Section 562, the Commissioners focused on two primary goals: providing certainty and preserving the pre-petition expectations of the parties. Given these policy considerations, the Commissioners determined that contract terms should govern the damages calculations in the first instance, unless manifestly unreasonable. In addition, in the event the contract


is silent on damages, or the contract provides a manifestly unreasonable methodology, the assets should be valued on the earliest date for which market prices are available.

5. Executory contracts, intellectual property licenses and unexpired leases of commercial property

a. Executory contracts

As a general matter, a debtor is free to assume or reject an executory contract if the debtor determines, in the exercise of its business judgment, that doing so is in the best interest of the estate. The debtor’s right to assume or reject is limited only to contracts that are in fact “executory” as of the date of the filing of the petition. Historically, most courts have defined an executory contract in accordance with the formulation propounded by Professor Vern Countryman, i.e., it is “a contract under which the obligations 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.” Because not every court has followed this definition, the Commissioners propose that the Code be modified to make clear that the Countryman definition applies in all cases, provided that mere forbearance does not make a contract executory.

Second, the Commissioners propose codifying existing case law which requires that a nondebtor party to an executory contract continue to perform pending assumption or rejection by the debtor, provided that the debtor pays for any post-petition products and services on a timely basis in accordance with the parties’ contract. Third, the Commissioners propose that any contract or lease that is neither assumed nor rejected — which usually occurs through inadvertence — be deemed to simply “ride through” the bankruptcy unaffected. A debtor can always override this default rule in its reorganization plan by providing for the deemed assumption or rejection of all executory contracts and unexpired leases, consistent with the approach taken by most reorganizing debtors.

Finally, the Commissioners propose a change to the requirement that a debtor must cure all defaults under an executory contract as a condition to assumption of such contract. In particular, courts have split on the implications of historical, nonmonetary defaults that are not capable of being cured, e.g., a debtor who breaches a covenant to continue operating in a leased location cannot go back in time and cure such a default. Amendments made to the Code in 2005 made clear that a debtor need not cure such defaults under unexpired leases. The Commissioners propose that the same rule apply for all other executory contracts as well.

b. Intellectual property licenses

The law relating to licenses of intellectual property has been especially fractured and vexing for reorganizing debtors and licensors of copyrights, trademarks and trade names. As a general matter, a debtor may assume, or assume and assign, an executory contract or unexpired lease notwithstanding any provision therein or in applicable law that restricts assignment. However, courts have split on whether a debtor may assume a license of intellectual property, under which the debtor is the licensee, without the licensor’s consent. A requirement that the licensor consent to any assumption obviously

50 See Perlman v. Catapult Entm’t, Inc. (In re Catapult Entm’t, Inc.), 165 F.3d 747 (9th Cir. 1999) (no assumption without licensor’s consent); RCI Tech. Corp v. Sunterra Corp. (In re Sunterra Corp.), 361 F.3d 257 (4th Cir. 2004) (same); but see Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997) (allowing assumption over licensor’s objection).
affords the licensor enormous potential leverage over a reorganizing debtor. The Commissioners therefore propose clarifying that a debtor may assume such licenses, regardless of any requirement of the license or applicable intellectual property law that requires the licensor’s consent.

The Commissioners likewise determined that a debtor should be free to assume and assign its rights as licensee, subject only to the nondebtor licensor’s right to object if the proposed assignment is to one of the licensor’s competitors. In order to block a proposed assignment on this basis, the nondebtor licensor bears the burden of establishing that the hardship imposed on it significantly outweighs any benefits to the debtor’s estate.

Finally, the Commissioners recommend that the Bankruptcy Code definition of “intellectual property” be broadened to include “trademarks,” “service marks” and “trade names,” thereby allowing a debtor-licensee to assign its rights to such items. One of the key implications of this expanded definition of intellectual property concerns situations where the debtor is the licensor, and the debtor proposes to reject a trademark licensing agreement under which a nondebtor is the licensee. Under Section 365(n) of the Bankruptcy Code, a nondebtor licensee may elect to treat the rejection as either a termination of the license or, alternatively, a right to retain the license, subject to an obligation to continue paying for the license according to its terms.

Under the Commissioners’ proposed changes, a nondebtor, trademark licensee may take advantage of Section 365(n). However, in order to accommodate the unique attributes of trademarks, the Commissioners also propose amending Section 365(n) to require a nondebtor licensee electing to retain its rights under a rejected trademark license to comply in all respects with the license, including with respect to (i) the products, materials and processes permitted or required to be used in connection with the licensed marks, and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered in connection with the licensed marks. Conversely, the debtor-licensor would maintain the right to enforce quality control but otherwise would not have any continuing obligations to the nondebtor licensee.

c. Real property leases

Prior to 2005, Section 365(d)(4) of the Bankruptcy Code obligated a debtor to assume or reject any unexpired, nonresidential, real property lease under which the debtor was a lessee, within 60 days of the petition date. However, this tight deadline was subject to extension “for cause,” and extensions historically were liberally granted — including multiple extensions that collectively could span years. The statute was significantly altered in 2005 to provide for a 120-day assumption/rejection period that could be extended once, for 90 days, without the landlord’s consent. Subsequent extensions, however, require the landlord’s written consent. The Commissioners now propose a longer and more simplified construct that is more accommodative to large retailers who need more time to make assumption/rejection decisions. Under the proposal, debtors will have a single, one-year period in which to decide to assume or reject leases of nonresidential real property.

The Commissioners propose two other changes designed to balance the competing interests of landlords and their bankrupt tenants. Rejection of a lease constitutes a breach that gives the landlord an unsecured, pre-petition claim against the debtor, though the amount of that claim is capped at an amount equal to the rent reserved under the lease for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease. The Commissioners propose adding a statutory requirement that a landlord mitigate its damages in connection with any rejection, which would in turn reduce the amount of any capped rejection claim. Second, the Commissioners propose clarifying that a landlord’s claim for any unpaid, pre-petition rent should be allocated between pre-petition
and post-petition periods, with any claim for the former constituting a general unsecured claim and the latter constituting an administrative priority claim. This approach rejects the so-called “billing” method, which classifies the priority of a claim based solely on the fortuity of the date of invoice, *i.e.*, whether it comes due pre- or post-filing.

6. Labor and employee matters

a. Collective bargaining agreements and retiree medical obligations

The modification or rejection of a collective bargaining agreement is governed by Section 1113 of the Bankruptcy Code. Among other things, Section 1113 provides that before a debtor may file a motion to modify or reject a collective bargaining agreement, it must make a proposal to the authorized representative of the employees covered by such agreement that includes those modifications that are necessary to permit the debtor to reorganize and that assures that all creditors and affected parties are treated fairly and equitably.51 The debtor and the authorized representative are required to meet in good faith to discuss the proposal, but the debtor is free to file a motion to modify or reject the agreement at any time after the proposal has been made.

The Commissioners heard testimony that this statutory scheme did not foster meaningful negotiations, as a debtor could, consistent with Section 1113, serve a proposal and then file a motion shortly thereafter, which in turn would trigger relatively short, statutory deadlines for a hearing and ruling on the motion. Accordingly, the Commissioners recommend certain refinements to more clearly separate the bargaining process from the litigation process in order to encourage a negotiated resolution. Specifically, the Commissioners propose that the debtor first file a request for an initial court conference regarding the initiation of Section 1113 proceedings. The court should then be required to schedule a status conference that allows sufficient time for the authorized representative of the labor group to review the debtor’s request and initial proposal, as well as for the parties to meet and confer to discuss a timetable for conducting the negotiations and whether a mediator could assist in their discussions. The court should be empowered to hold multiple court conferences, but it should conduct a trial no later than an outside date equal to 180 days after the initial request for a conference.

Additionally, the Commissioners propose a change to the current statutory requirement that all interested parties appear and be heard on the debtor’s motion. In particular, following the protocol created in the *Delphi* reorganization case,52 and in an effort to reduce costs, the role of statutory committees would be limited to receiving and reviewing information from the debtor and authorized representative and evaluating the debtor’s business judgment regarding the decision to reject the agreement. Separately, the Commissioners determined to resolve a split in court decisions regarding whether rejection of a collective bargaining agreement gives rise to a claim for breach, by proposing that rejection should in fact allow the authorized representative to assert a general unsecured claim for monetary damages on behalf of affected employees.53

Finally, the Commissioners propose a change with respect to the law governing the modification of retiree medical obligations. A proposed modification of retiree medical obligations, governed by Section 1114 of the Bankruptcy Code, is subject to a requirement that the debtor make a proposal and follow a process similar to that governing proposed modifications of a collective bargaining agreement under Section 1113 of the Bankruptcy Code. However, some courts have ruled that a debtor need not

51 11 U.S.C. § 1113(b)(1)
52 Skadden was counsel to Delphi in its reorganization case.
comply with Section 1114 at all if the debtor establishes that it has the right under the pre-petition program documents to unilaterally modify or terminate the benefits. By contrast, the Third Circuit adopted a contrary approach, finding that a debtor is bound by Section 1114 regardless of whether the documents permit unilateral modification of termination. 54 The Commissioners sided with the Third Circuit in recommending that the Section 1114 procedures apply to all requested modifications to pre-petition retiree benefit plans, including those that are found to be terminable at will by the debtor outside of bankruptcy.

b. Employee severance liability

Severance payments to terminated employees may be based on either a fixed payment at termination or, alternatively, the terminated employee’s length of service. In general, courts treat fixed payment claims for employees terminated post-filing as administrative expense claims, whereas claims based on an employee’s length of service are allocated between pre-petition and post-petition claims according to when the severance benefits were earned, i.e., the relative length of service pre-filing versus post-filing. 55 Significantly, however, the Second Circuit long ago rejected the allocation method, even under plans based on length of service. 56 The Commissioners propose that the Bankruptcy Code be modified to clearly provide that the allocation method should control with respect to employees terminated post-petition under a severance plan based on length of service. Moreover, the pre-petition claim should be eligible for priority status, ahead of other general unsecured claims, in accordance with the statutory priority afforded unpaid wages, described further below.

c. WARN Act liability

Although there are exceptions, the Worker Adjustment and Retraining Notification (WARN) Act 57 generally requires covered employers to provide affected employees with at least 60 days’ advance notice prior to effecting a plant closing or covered mass layoff. If employees are terminated without such notice, they must receive 60 days’ pay. As a general matter, courts have held that WARN Act damages give rise to a right to payment upon the occurrence of the event triggering the violation, i.e., the employment termination or mass layoff. Thus, the timing of the termination generally determines the payment classification of WARN Act claims under the Bankruptcy Code: employees terminated pre-petition are entitled to pre-petition claims, subject to any defenses under WARN, whereas employees terminated post-petition are entitled to post-petition, administrative expense claims, again subject to any defenses under WARN.

One court held, however, that while the employees in the case before it had been terminated post-petition, their WARN Act claims were pre-petition claims because, according to the court’s interpretation of the WARN Act, the triggering event for purposes of WARN Act liability was the date the WARN Act notice of termination should have been given — which, according to the court, was pre-petition. 58 The Commissioners propose overruling this decision by providing that the event giving rise to WARN Act liability be loss of employment, not the date the notice should have been given. Thus, when a plant closing, mass layoff or other triggering event under the WARN Act occurs on or after the filing of the bankruptcy

54 IUE-CWA v. Visteon Corp. (In re Visteon Corp.), 612 F.3d 210 (3d Cir. 2010).
55 See e.g., Lines v. Sys. Bd. of Adjustment No. 94 (In re Health Maint. Found.), 680 F.2d 619, 621 (9th Cir. 1982) (discussing the differing treatment for severance in lieu of notice and severance based on length of employment).
57 29 U.S.C. §§ 2101-2109
petition, damage claims should be treated as administrative claims for the number of post-petition days comprising the violation.

d. Payment of priority wage claims

Section 507(a)(4) of the Bankruptcy Code currently provides priority status for unpaid wages and other compensation, up to $12,475 per employee, earned by the employee during 180 days before the earlier of the petition date or the date of the cessation of the debtor’s business. Section 507(a)(5) currently provides priority status for unpaid employer contributions to employee benefit plans for services provided during the same window, up to $12,475 per employee, less any amounts paid to such employee under section 507(a)(4). These statutes have presented two challenges to employees and their reorganizing employers. First, the calculation of precise priority amounts often can be complex and time-consuming. Second, while the amounts were entitled to priority, they could not be paid without a court order.

The Commissioners propose to simplify these matters. First, they propose that Sections 507(a)(4) and (a)(5) be combined to create a single overall cap of $25,000 per employee, without an earnings period limit, covering both wages and employee benefit plan contributions on a per-employee basis. In the event the cap is insufficient to satisfy all covered claims, the amount will be applied first toward wage claims and second toward employee benefit plan contributions claims. Second, the Commissioners propose that priority amounts be payable without the need for a court order. This is significant in part because one of the most time-consuming and expensive motions a debtor and its professionals must prepare and present to a bankruptcy court in connection with the so-called “first-day” hearing is a motion to honor pre-petition wages and related benefits in the ordinary course. Such motions typically span dozens of pages, describing in minute detail virtually every aspect of a debtor’s employee compensation programs. The Commissioners’ suggested approach should allow this motion to be significantly streamlined or, in appropriate cases, eliminated altogether.

7. Selected vendor matters

a. Doctrine of necessity formally codified

Debtors frequently file “first-day” motions requesting authority to honor pre-petition wage and salary claims, and to pay the pre-petition claims of so-called “critical” or “essential” vendors. The authority for such requests is the doctrine of necessity, a court-created concept that authorizes extraordinary payments to selected creditors outside the plan context where such payments are necessary to preserve and enhance the value of the enterprise for all stakeholders. The Commissioners propose codifying the doctrine of necessity. Accordingly, courts should have the authority to enter orders authorizing payments for claims on account of vendor goods or services for which the debtor establishes an evidentiary record supporting such extraordinary relief. However, such relief is not available for claims qualifying for priority treatment under Section 503(b)(9) of the Bankruptcy Code, described below, unless the court finds that some relief is compelled for a particular kind of good by applicable non-bankruptcy law that is not otherwise pre-empted by the Code and is not deemed a disguised priority.

b. Section 503(b)(9) claims

Section 503(b)(9) provides administrative claim treatment to trade creditors for the value of goods (but not services) received by the debtor in the ordinary course of business within the 20 days preceding the filing. The Commissioners propose two minor changes to this statute. First, while the statute refers to goods received by the debtor, the Commissioners suggest clarifying that the statute should
apply in cases of goods that are shipped and received by a person other than the debtor on the debtor’s behalf. Second, the Commissioners propose amending current law, which contemplates that creditors with Section 503(b)(9) claims must incur the expense of filing a formal motion for payment, by authorizing instead the filing of a simpler, proof of claim form.

8. Estate fiduciaries and professionals

a. Creditors’ committees

The Bankruptcy Code mandates the creation by the U.S. Trustee of a statutory committee of unsecured creditors in every Chapter 11 case to represent the interests of unsecured creditors generally.59 Once appointed, the committee serves as a fiduciary for all unsecured creditors. Committees are often active in, among other things, investigating the debtor’s affairs, prosecuting avoidance actions and participating in the plan formulation or sale process. The Commissioners examined the role of statutory creditors’ committees and determined that no change to existing law was warranted, subject only to a suggested change to the “for cause” standard, pursuant to which courts have authorized the U.S. Trustee not to appoint a committee in certain cases. According to the Commissioners, the “for cause” determination should include consideration of whether unsecured creditors are out of the money, will be paid in full or otherwise do not have a stake in the proceedings.

b. The “estate neutral”; elimination of examiners

The Bankruptcy Code currently provides that an examiner may be appointed to investigate the debtor and estate claims if such appointment is in the best interests of stakeholders, and must be appointed upon motion if the debtor’s fixed, liquidated, unsecured debts exceed $5 million.60 The Commissioners considered the role of examiners, concluding that they can be beneficial to the Chapter 11 process, including by assessing the merits of claims asserted in the case, identifying additional potential claims and providing substantial information to parties regarding the debtor and the case. On the other hand, the Commissioners recognized that examiners added an additional layer of costs and delay to the process and that they may perform functions that could be performed by the debtor or by a creditors’ committee.

The Commissioners therefore recommended replacing the examiner concept with a more flexible, “estate neutral” concept. Significantly, the Commissioners propose elimination of any mandatory appointment of an estate neutral in favor of a standard that requires appointment only if in the best interest of the estate or otherwise for cause. An estate neutral could be appointed where an independent assessment was needed or where doing so could reduce information asymmetries or facilitate dispute resolution. This suggests that the estate neutral role could be expanded to incorporate the role currently filled by mediators and facilitators. However, the estate neutral would not be empowered to propose a plan, act as a mediator unless that is the primary purpose of the appointment, initiate litigation unless that is within the scope of the original appointment and the estate neutral did not previously investigate the claims at issue, or operate the debtor’s business except in certain smaller cases.

c. Compensation matters

The Commissioners propose three changes governing the retention and compensation of professionals that collectively are designed to further incentivize professionals to provide services in a cost-effective manner. First, while the Commissioners questioned the accuracy of the perception that professional

59 11 U.S.C. § 1102(a)(1)
60 11 U.S.C. § 1104(c)
fees in Chapter 11 were excessive or disproportionate to the value provided by professionals, they nonetheless recommended revising the Bankruptcy Code to allow for the court’s approval, at the time of retention, of alternative fee arrangements, including fixed fees, flat fees, task-specific fees and contingent fees. In determining whether a particular proposal benefits the estate, the Commissioners recommend that a bankruptcy court consider the potential positive and negative impacts of the arrangement and whether such arrangement is on customary, non-bankruptcy, market terms. Once approved ex ante, the Commissioners propose that the arrangement should not be altered ex post, except in limited circumstances.

Second, the Commissioners concluded that there should be a clear distinction between an estate’s bankruptcy and nonbankruptcy professionals, with only the former required to comply with the Code’s strict retention and compensation procedures and standards set forth in Sections 327 and 330. Nonbankruptcy professionals are those who provide services outside the bankruptcy context that would have been required even if the debtor had not filed a Chapter 11 petition. The Commissioners found that, typically, the services provided by and the compensation paid to these nonbankruptcy professionals did not warrant the time and expense associated with complying with the Code’s burdensome retention and compensation provisions. To ensure that all bankruptcy professionals are properly identified, however, the Commissioners recommended that debtors file quarterly reports identifying all nonbankruptcy professionals and briefly describing the services such professionals provide, subject to the right of parties to review and object to the classification of a particular professional.

Finally, with respect to professionals retained by secured creditors, ad hoc committees or other third parties, the Commissioners expressed some concern that the parties often stipulated to the reasonableness of the professionals’ fees in connection with obtaining authorization for payment of such fees, such that the fees were not meaningfully evaluated. To address this concern, the Commissioners voted to require the review of such professionals’ fees under the reasonableness standard of Section 330(a). To limit costs, however, the Commissioners stopped short of requiring that such professionals be subject to the formal fee application process.