Chapter 11 of the Bankruptcy Code: As It Was, As It Is, and As It May Be

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Introduction

Cases under Chapter 11 of the United States Bankruptcy Code[1] have changed much since the Code's enactment in 1978. In first decade and a half or so immediately after the Code became effective, most Chapter 11 proceedings followed a defined path. In most instances, upon the commencement of the case, the debtor's management would remain in possession of the debtor's assets and continue to operate the enterprise. During the course of the Chapter 11 proceeding, the debtor would negotiate with the constituent creditor groups in an effort to formulate a plan of reorganization. The plan would separate creditors and equity interest holders into classes and provide for the treatment of the claims or interests in each class. Among other things, the factual circumstances of the debtor's history before and during the Chapter 11 case, the terms of plan, alternatives to it, and the effects of liquidating the debtor's assets would be detailed in a court approved disclosure statement. The disclosure statement, the plan, and a ballot would be transmitted to creditors and interest holders soliciting their vote on confirmation of the plan.

Assuming that each class of creditors and interest holders accepted the plan by an affirmative vote of a majority in numbers and two-thirds in dollar amount of creditors or interest holders voting in the class,[2] and if the other requisites of Code Section 1129 were met,[3] the plan would be confirmed by the bankruptcy court. If one or more classes of creditors or interest holders rejected the plan, the Code provided a means for the plan to be "crammed down" on dissenting classes and nonetheless be confirmed.[4] Confirmation re-vested the property of the bankruptcy estate in the debtor. The plan became a new contract pursuant to which the debtor agreed to pay some or all of its debts, usually on

[1] 11 U.S.C. §§ 101-1532 (hereinafter the "Code").

[2] § 1126 of the Code.

[3] These included, among other things, the payment of all accrued administrative expenses, the plan being proposed in good faith and not by any means prohibited by law, each creditor receiving at least what it was entitled to receive in a Chapter 7 liquidation unless the creditor agreed otherwise (known as the best interest of creditors test), and the plan being feasible and able to be performed. *See* § 1129 of the Code.

[4] *See* § 1129(b) of the Code, which provides the basis upon which a plan may be confirmed, notwithstanding the absolute priority rule (*e.g.*, subordinate classes cannot retain or receive any distribution under a plan unless senior classes accept it).

modified terms. If the plan was accepted by the classes of unsecured classes senior in priority to the equity interest holders (or the debtor met the requirements to cram down the plan), equity interest holders retained their equity interests in the reorganized debtor. The anticipated negotiation with creditors, the court approved disclosure statement, the right of creditors to vote on the plan, and the requirement that the bankruptcy court ensure that the plan conformed with the strictures of the Code to be confirmable, were all essential creditor protections that Congress built into the Chapter 11 process. As a young bankruptcy lawyer immediately following the Code's enactment, my practice involved representing debtors and creditors in Chapter 11 cases confronting a myriad of legal issues pertaining to formulation and confirmation of plans of reorganization.

In most instances, Chapter 11 cases today bear little resemblance to the process Congress originally envisioned. This chapter will review the evolution of Chapter 11 from a process by which the owners of an enterprise readjusted creditor obligations and entered into a "new deal" with their creditor constituencies, to a mechanism by which assets of a going concern business are quickly conveyed with few of the essential creditor protections Congress built into the Code. Also, the chapter will highlight certain aspects of the report of the American Bankruptcy Institute Commission on Chapter 11,[5] which attempt to reconcile what Chapter 11 cases used to be and what they are today. This will perhaps provide a glimpse into what Chapter 11 cases may become in the future.

Chapter 11, As It Was: Plans of Reorganization, Not Sales of Substantially All of the Assets

In the first decade and a half or so after the Code's enactment, most Chapter 11 cases were commenced with the goal of confirming a plan of reorganization under the process outlined previously. If reorganization was not achievable, the case was usually converted to a Chapter 7 proceeding and the assets were liquidated for the benefit of creditors. Code Section 363 provided for the sale of assets outside of the ordinary course of business with court approval if the sale was in the best interests of creditors. However, early decisions refused to permit sales of substantially all of a debtor's assets without the creditor protections of a disclosure statement, creditor voting, and confirmation of a plan by the bankruptcy court.

Three of these early decisions are noteworthy. In *In re White Motors Credit Corp.*,[6] which was perhaps the first decision to grapple with the issue of a sale of substantially all of the assets outside a plan, the United States Bankruptcy Court for the Northern District of Ohio considered a motion to sell substantially all of the debtor's and its affiliates' truck manufacturing assets to a subsidiary of AB Volvo ("Volvo"). The motion indicated that under the terms of the June 9, 1981, purchase agreement between the debtors and Volvo, unless the sale closed by August 31, 1981, Volvo had the right to withdraw its offer. The Official Creditors Committee, the subordinated debt and equity security holders, and the Securities and Exchange Commission all opposed the sale in the absence of a proposed plan unless the debtor could show the existence of an emergency. The court observed that the sale to Volvo would attempt to accomplish the reorganization of the debtor under the administrative power of Code Section 363, side-stepping the procedural safeguards of a court approved disclosure statement, a vote, and the confirmation standards enumerated in Code Section

[5] American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations* (2014), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.
[6] *In re White Motors Credit Corp.*, 14 B.R. 584 (Bankr. N.D. Ohio 1981).

1129.[7] The debtor, the court noted, had received eight extensions of the exclusive period to file a plan of reorganization, but had not filed a plan.

The court acknowledged that a sale under Code Section 363 of substantially all of a debtor's assets had not been decided by other courts.[8] The court extensively reviewed the 1973 Report of the Commission on Bankruptcy Laws of the United States,[9] which was the genesis of Code Section 363(b), and concluded:

> As a matter of legislative intent, to endow Section 363 with the purpose of or a potential for total reorganization would nullify, at the debtor's option, the major protections and standards of Chapter 11 of the Code. . . . It is clear, and the Court holds accordingly, that in a chapter 11 reorganization under the Bankruptcy Code, Section 363(b) does not authorize the sale of all or substantially all of the assets of the estate.[10]

Regarding the existence of an emergency, if there was an emergency, the court found that it was one of the debtor's own making.

Two years later, in *In re the Lionel Corp.*,[11] the Second Circuit Court of Appeals considered an appeal of an order approving a motion to sell the debtor's 82 percent share in a subsidiary outside of a plan of reorganization under Code Section 363 over the objection of the Equity Security Holders Committee. The Official Committee of Unsecured Creditors (the "Committee") urged the court to approve the sale as being in the best interests of creditors, the standard required by Code Section 363(b). The Court examined the history of cases decided under the prior Bankruptcy Act. While the language of Section 363(b) of the Code seemed to give bankruptcy judges unfettered discretion to sell property of the estate outside of the ordinary course of business,[12] the Court noted that Congress specifically enacted the procedural safeguards of disclosure, voting, acceptance, and confirmation found in Chapter 11.

While the court rejected the concept that only an emergency would justify the sale of substantially all of the debtor's assets under Code Section 363(b), it held that there must be some articulated business reason other than the appeasement of major creditors for using the section to sell the assets out of the ordinary course of business.[13] In making that determination, the Bankruptcy Court should consider, among other things, the time which has elapsed since the filing of the case, the likelihood that a plan will be filed, and the effect of the proposed disposition on future plans of reorganization.[14]

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[7] *Id.* at 587-588.
[8] *Id.*
[9] Report of the Commission on Bankruptcy Laws of the United States, H.R. Doc. No. 93-137,93rd Cong., 1st Sess. (1973).
[10] *In re White Motors Credit Corp.*, 14 B.R. at 590.
[11] *Comm. of Equity Security Holders v. Lionel Corp. (In re the Lionel Corp.),* 722 F.2d 1063 (2d Cir. 1983).
[12] *Id.* at 1071.
[13] *Id.* at 1070.
[14] *Id.* at 1071.

That same year, the Fifth Circuit Court of Appeals also addressed a proposed sale of substantially all of the assets of a Chapter 11 debtor outside of the plan of reorganization in *In re Braniff Airways, Inc.*[15] The debtor proposed to enter into an agreement with Pacific Southwest Airlines ("PSA") which provided for the transfer of Braniff's cash, airplanes and equipment, terminal leases, and landing slots to PSA in exchange for travel scrip, unsecured notes, and a profit participation in PSA's proposed operations. The agreement also had the effect of dictating the terms of any future plan of reorganization, by including that the transferred scrip be used only in a future Braniff reorganization and issued to specified parties, the granting of third-party releases, and the requirement that secured creditors vote their deficiency claims in favor of any future plan approved by a majority of unsecured creditors.. The Court held that the "debtor. . . should not be able to short circuit the requirements of Chapter 11 for confirmation of a plan of reorganization by establishing the terms of the plan *sub rosa* in connection with the sale of assets."[16] Any attempt to dictate the terms of a plan of reorganization in connection with a sale, said the Court, must scale the hurdles of Chapter 11 including disclosure, voting, the best interest of creditors test, and the absolute priority rule.[17]

The principles enunciated in these cases established the ground rules that bankruptcy courts applied for the first decade and a half following the enactment of the Bankruptcy Code. To understand the underpinnings of decisions like *White* and *Lionel,* it is important to understand the financial context in which distressed businesses, especially middle market companies, found themselves. During that period, the amount of secured indebtedness was often less than the value of the collateral it encumbered. Because there was equity in the collateral, a debtor had a strong position *vis a vis* its senior lender, including the ability to obtain court approval for using cash collateral or to obtain debtor in possession (DIP) financing from a third party on a senior lien basis to finance the operations during the bankruptcy case. The debtor could also use the threat of—or the actual application of—cram down to confirm a plan over the objection of its secured creditors. If a plan was confirmed, the future profits of the enterprise would be available to pay the unsecured creditors giving them a stake in the future success of the reorganized debtor. This facilitated negotiations with the senior lender and the Committee over the terms of the plan. With these dynamics, assuming that any structural shortcomings of a business could be corrected, confirmation of a plan of reorganization was achievable in many cases.

Chapter 11, As It Is: Sales of Substantially All of the Assets Instead of Plans of Reorganization—Functionality Not Formalism

In the last two decades, the dynamics facing distressed enterprises have radically changed, especially for middle market companies. In the years immediately prior to the financial crisis of 2008, obtaining financing was surprisingly easy and many companies found themselves vastly overleveraged. Debts owed to the senior lender far exceeded the value of the collateral. Upon filing bankruptcy, obtaining authority to use cash collateral, or obtaining debtor-in-possession (DIP) financing from a third party over the objection of the senior lender was virtually impossible because the debtor could not provide adequate protection in the form of a replacement lien or an equity cushion. Moreover, the senior lender was often the largest secured claimant, and because of its deficiency claim, it was also the largest unsecured claimant in the case. Consequently, the senior lender was able to block confirmation of any proposed plan of reorganization. The Committee had little leverage to negotiate

[15] *Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.),* 700 F.2d 935 (5th Cir. 1983).
[16] *Id.* at 940.
[17] *Id.*

for a sharing in the future profits of the debtor, because without the consent of the senior lender, the debtor would not survive to achieve any future profits.

In addition, with experience, lenders became much smarter about the Chapter 11 process. In the past, senior lenders who had favorable loan-to-collateral value ratios often agreed to allow the debtor to use cash collateral or agreed to provide DIP financing to protect themselves from the imposition of a priming lien by a third-party DIP lender. Often, this obligated the senior lender to financially support an expensive Chapter 11 proceeding. The lender had little choice but to fund mounting administrative expenses incurred by the debtor's counsel and financial advisor, the Committee counsel and financial advisor, and all other professionals appointed in the case. The sheer magnitude of accruing administrative expenses—which did nothing to repair the structural deficiencies of the debtor—often doomed the case. Additionally, cases often lasted for years without any certainty that an acceptable plan of reorganization would ultimately be confirmed.

Following the maxim "your first loss is your best loss," in the changed financial milieu of leveraged loans, senior lenders often controlled both the secured and unsecured creditor classes. Using that position, they conditioned essential DIP financing—which was unavailable elsewhere—upon the accomplishment of a quick sale of substantially all of the debtor's assets under Code Section 363. The agreement to provide DIP financing was often also coupled with a cap on the administrative expenses which could be incurred. The senior lender viewed a sale of the going concern enterprise as a much faster and more predictable method of recouping the maximum amount of its indebtedness. The debtor had little choice but to accede to the lender's demands or be forced to liquidate its assets. The role of the Committee was limited to negotiating the terms of the sale process and bargaining for receipt by the unsecured creditors of a "carve-out" of a portion of the sale proceeds otherwise due to the senior lender, which would at least return something to their constituency. Usually, the Committee's only alternative was objecting to the sale process and, if successful, facing the likely liquidation of the debtor and the recovery of nothing by the unsecured creditors. Not surprisingly, the Committee most often chose to accept a minimal carve-out and join with the senior lender and the debtor in asking the court to approve the sale.[18]

Faced with this united front, bankruptcy courts had to weigh whether approving the sale served the interests of creditors better than denying the motion to sell, and the likely resulting liquidation. This calculus was influenced by the fact that the sale process usually incorporated competitive bids and held out at least the prospect that the business and the jobs it supported would be preserved. Again, it is not surprising that in this climate most courts found that there were sufficient business reasons to approve the sale. The vast majority of Chapter 11 cases filed today result in a sale of substantially all of the debtor's assets under Section 363 of the Code. Post-sale, the Chapter 11 case concludes by confirmation of a plan of liquidation distributing the sale proceeds, a conversion to a Chapter 7, or occasionally, with a structured dismissal of the case.[19] . If asked to describe my current practice, I would reply that I primarily represent debtors, creditors, lenders and purchasers in distress merger and acquisition transactions. The issues I grapple with relate to the sale process and rarely to issues involving plan formulation or confirmation.

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[18] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy,* 55 Stan. L. Rev. 751 (2002), wherein the authors argue that the days when reorganization law provided substantial benefits are gone and that Chapter 11 now serves as a forum in which sales are conducted.

[19] In fact, many cases involve a twist on this paradigm with a hedge fund purchasing senior indebtedness at a discount and immediately forcing a Chapter 11 filing. Thereafter, the fund credit bids its indebtedness up to the face amount in the Section 363 sale, executing a classic "loan to own" strategy. *See* § 363(k) of the Code.

Most courts currently considering whether to approve full asset sales under Code Section 363 utilize the same analytical framework as the courts in *Lionel* and *Braniff*, but come to different results. Two noteworthy cases illustrate the point. In *In re General Motors Corp*,[20] United States Bankruptcy Judge Robert E. Gerber begins by reviewing the provisions of Code Section 363(b), concluding:

> Notably, Section 363 has no carve outs from its grant of authority when applied in cases under Chapter 11. Section 363 does not provide, in words or substance, that it may not be used in Chapter 11 cases for dispositions of property exceeding any particular size, or where the property is of such importance that it should alternatively be disposed under a plan. Nor does any other provision of the Code so provide.[21]

Judge Gerber noted that the Second Circuit in *Lionel* specifically rejected the requirement that there must be an emergency to justify the sale of substantially all of the assets, ruling instead that there must be some articulated business reason for the sale before a bankruptcy court can approve it.[22] The court observed that , in four cases decided subsequent to *Lionel*, the Second Circuit used the "articulated business reason" standard to authorize sales of substantially all of the assets of the respective debtors' assets. .[23] Regarding the prohibition of *sub rosa* plans as articulated in *Braniff*, the Court said that converting a debtor's assets to cash and assuming some, but not all, of a debtor's liabilities does not constitute a *sub rosa* plan.[24]

In the second case, *In re Chrysler LLC*,[25] in a sweeping decision, the Second Circuit upheld the sale of substantially all of the assets of Chrysler, finding that such asset sales had become common place and that the sale did not constitute a *sub rosa* plan. Six months after this opinion, in an extremely unusual decision, the United States Supreme Court granted the petition for certiorari, vacated the Second Circuit's decision and remanded with instructions that the appeal be dismissed as moot. It is unclear what the Supreme Court intended, but it may have wanted to prevent the Second Circuit's very broad decision from becoming binding precedent. However, because the Second Circuit's decision may represent the "high water mark" of Code Section 363 sale decisions, it is useful to examine its decision.

The Second Circuit began by noting the tension between the benefit of speed and efficiency permitted by Code Section 363 sales and the otherwise applicable features and creditor safeguards of the Chapter 11 plan process. To balance these concerns, *Lionel* required a showing of a good business reason before a sale of substantially all of a debtor's assets could be approved.[26] The Court observed that in the twenty-five years since *Lionel*, Section 363 sales had become "common practice," and that

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[20] *In re General Motors Corp.*, 407 B.R. 463 (Bankr. S.D.N.Y. 2009); *aff'd*, 428 B.R. 43 (S.D. N.Y. 2010), and *aff'd*, 430 B.R. 65 (S.D. N.Y. 2010), *and subsequent determination* 457 B.R. 276 (Bankr. S.D. N.Y. 2011).
[21] *Id.* at 486.
[22] *Id.* at 488-489.
[23] *Id.* at 489.
[24] *Id.* at 496.
[25] *In re Chrysler LLC*, 576 F.3d 108 (2d Cir 2009); *cert. granted, judgment vacated*, 558 U.S. 1087 (2009), *and judgment vacated*, 592 F.3d 370 (2d Cir. 2010).

[26] *Id.* at 114.

such sales had become even more useful and customary in the economic crisis of 2008–2009.[27] In an excellent summary of the benefits of the process, the Court said:

> Resort to § 363(b) has been driven by efficiency, from the perspectives of sellers and buyers alike. The speed of the process can maximize the asset value by sale of the debtor's business as a going concern. Moreover, the assets are typically burnished (or "cleansed") because (with certain limited exceptions) they are sold free and clear of liens, claims and liabilities . . . A §363 sale can often yield the highest price for the assets because the buyer can select the liabilities it will assume and purchase a business with cash flow (or near prospect of it). Often, a secured creditor can "credit bid," or take an ownership interest in the company by bidding a reduction in the debt the company owes.[28]

The Court then addressed the objection of certain Indiana pension plans that the Chrysler's sale motion violated *Braniff's* prohibition of sale motions constituting *sub rosa* plans. The Court observed that Code Section 363(b) specifically authorizes sale of a debtor's assets, and that if more assets were included in the sale, less would be available for any plan of reorganization. The term "*sub rosa*," said the court, suggests something covert or secret which clearly does not apply to a Section 363 transaction.[29] The court read *Braniff* to hold that a sale of substantially all of a debtor's assets may be a reorganization without being the type proscribed in which the terms of any future plan are dictated in the purchase agreement and the sale order. The court applied the concept of functionalism instead of formalism, finding that the only alternative to a sale (which would yield $2 billion) was immediate liquidation (which would yield $800 million).[30]

The jurisprudence of Code Section 363 sales of entire enterprises has come full circle in almost three decades. In *White Motors,* the court found Volvo's imposed closing deadline was not sufficient emergency to justify the sale outside of a plan. By contrast, in *Chrysler*, Fiat's mandated closing deadline was acceptable even though the Court noted that it was "tight and seemingly arbitrary," with the debtor having little leverage to extend it.[31] While because of their size, *General Motors* and *Chrysler* are not typical Chapter 11 cases, the legal principles which those courts applied are the same principles currently being applied in small, medium, and large cases across the United States today. Courts recognize that given the capital structure of most debtors, reorganization under a plan as envisioned by Congress in 1978 is not a likely possibility. Courts realize that if they insist upon strict adherence to the requisites and creditor protections of plan confirmation under Chapter 11, the parties risk a liquidation and minimal recovery for the unsecured creditors.

Chapter 11, As It May Be: The ABI Commission Report

Today, Code Section 363 sales dominate the Chapter 11 landscape and there is little evidence that plans of reorganization will reemerge as the desired goal in most cases. Although prompt sales often preserve value yielding more—sometimes far more—than liquidation and also minimize the burden

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[27] *Id.* at 114-115.
[28] *Id.* at 115-116.
[29] *Id.* at 117.
[30] *Id.* at 118
[31] *Id.* at 119. The court also noted that Chrysler was losing going concern value of almost *$100 million each day.* This is exceptional, but ongoing losses are present in many Chapter 11 cases, forcing courts to grapple with this reality, although on a much smaller scale.

of administrative expenses which often doom small- to mid-sized cases, the process still leaves most unsecured creditors disenfranchised with little chance to evaluate their options. The breathing spell which Congress envisioned Chapter 11 would afford debtors has often become only a short gasp before the case is effectively over, with secured creditors dictating the timeline.

In 2012, the American Bankruptcy Institute established a Commission to evaluate Chapter 11 of the Code as it is utilized today, and to make recommendations for proposed reforms. While the Commission's December 2014 Report[32] addresses a myriad of issues relating to the administration of Chapter 11 cases, key sections of the report deal with the tension between the creditor protections provided by the plan process and the practical expediency achieved by a sale of substantially all of a debtor's assets.

The Commission acknowledges several important realities of Chapter 11 today. Chapter 11 cases are too expensive, especially for small and mid-sized debtor enterprises.[33] The amount of leverage in and complexity of capital structures in companies today is much different than that which existed in debtors when the Code was enacted in 1978.[34] And because of these factors, sales of substantially all of a debtor's assets in Chapter 11 cases have by necessity become an integral part of Chapter 11 practice.[35]

However, the Commission also recognizes that Code Section 363 sales do not provide creditors with the same protections afforded by the process of confirming a Chapter 11 plan.[36] In addition, prepetition lenders use their leverage in agreeing to provide essential DIP financing to set milestones for asset sales. These sales are accomplished so quickly that creditors have little chance to have meaningful input into the sale process or any ability to ensure that the proposed sale is the best option available.[37] Finally, small to mid-sized enterprises have little chance of successfully reorganizing under the present statute, leaving them with few alternatives --- liquidate or sell their assets utilizing what the Commission believes are sub-par remedies, such as state law receiverships.[38]

In response, the Commission proposes reforms that address, among other things, the timing of proposed Code Section 363 sales, the standards a court should apply when considering such a sale, the value junior creditors should reasonably expect to receive from a sale which would otherwise foreclose any future right to profits, the information that should be available to creditors in connection with a proposed sale, and, finally, the changes that would make Chapter 11 a realistic alternative for small and medium sized business debtors.

Fixing the Timing to Expand the Debtor's Breathing Spell

The Commission observed that many DIP financing motions filed on the first day of the case include sale milestones such as a date for the entry of bidding procedures orders, sale orders, and closing dates. The DIP financing order also often establishes conditions for bidding in a Code Section 363

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[32] *American Bankruptcy Institute, Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations.*
[33] *Id. at 12, 56, 59.*
[34] *Id. at 12.*
[35] *Id. at 229.*
[36] *Id. at 205-206.*
[37] *Id. at 81, 86.*
[38] *Id. at 283.*

sale.[39] The Commission recommends that courts not approve DIP financing orders containing milestones within the first sixty days after the petition date.[40] Similarly, the Commission notes that sales of substantially all of a debtor's assets, what the Commission calls "Section 363x sales," have been approved by courts on ever decreasing timeframes relying on rationales other than the emergency "melting ice cube."[41] The Commission also concludes that the speed with which these sales are accomplished potentially reduces value available for the stakeholders, and recommends that absent the most extraordinary circumstances proven by clear and convincing evidence, Section 363x sales should not be approved within the first sixty days of the case.[42]

There is an obvious tension between the need to accomplish a sale quickly to prevent further erosion of value and the need for meaningful creditor protections and participation. While sixty days is greater than the timeframe in which courts are requested to rule on many Code Section 363 sales, it is probably insufficient if there is not a real emergency. A Committee may not be organized and have the opportunity to select counsel for several weeks. Moreover, the Commission's recommendations only preclude a court ruling on a Code Section 363 motion within the first sixty days of the case. The motion could be prepared and filed with notice given so that the hearing to approve it is on or about the sixtieth day. Nonetheless, the recommendations regarding excluding sale milestones in DIP financing orders and delaying court approval of Code Section 363 sales within the first sixty days of the case is a change from present practice.

Establishing the Standards for a Sale of Substantially All of a Debtor's Assets

The Commission recognizes that while there may be little difference in the consequences to creditors' rights under an order confirming a plan or an order for the sale of assets, there are significant differences in the creditor protections available under the two processes.[43] Courts and commentators note that Section 363x sales skirt the notice and due process protections of the plan process, often before creditors can assess the debtor's restructuring alternatives.[44]

To remedy these shortcomings, the Commission proposes that no Section 363x sale be approved unless the following requirements are met:

1. The sale complies with the applicable provisions of the Bankruptcy Code. (Comparable provision found in Code Section 1129(a)(1).)
2. The proponent of the sale complies with the applicable provisions of the Code. (Comparable provision found in Code Section 1129(a)(2).)
3. The sale is proposed in good faith and not by any means forbidden by law. (Comparable provision found in Code Section 1129(a)(3).)
4. Any payment made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in or in connection with the case, or in connection with the sale and incident to the case, has been approved by or is subject to approval by the court as reasonable. (Comparable provision found in Code Section 1129(a)(4).)

[39] *Id.* at 80-82.
[40] *Id.* at 79-80.
[41] *Id.* at 86.
[42] *Id.* at 87.
[43] *Id.* at 206.
[44] *Id.* at 204.

5. Except to the extent that the holder of a particular claim has agreed to different treatment of such claim, the trustee proposes to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of a kind specified in Code Section 507(a)(2) [administrative claims] or (3) [gap claims in an involuntary case]. (Comparable provision in Code Section 1129(a)(9)(A).)
6. All fees payable to the US Trustee have been paid or will be paid as of the date of closing. (Comparable provision found in Code Section 1129(a)(12).)
7. The Trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection to a purchaser in the order approving the sale.[45]

While these protections incorporate a number of Code Section 1129 safeguards and are more than what is currently available in most Code Section 363(b) sales, they do not afford the ability to vote on the transaction or include the protections of the absolute priority rule present in a plan confirmation.

Providing More Information

Noticeably absent from the Commission's recommendations is the approval and dissemination of a disclosure statement type document which provides creditors with adequate information sufficient to analyze and perhaps object to the sale. The Commission recognizes that a debtor's timely and full disclosure of essential information is a necessary component of the Chapter 11 process, and that without this information parties in interest cannot assess the debtor's reorganization efforts or make meaningful decisions about the case.[46]

The Commission also concludes that financial information is perhaps the disclosure of most importance to creditors.[47] Consequently, as an alternative to a disclosure statement analog, the Commission recommends that with any motion filed under Code Section 363, the debtor prepare a valuation information package (VIP), which contains:

1. tax returns for the previous three years;
2. annual financial statements (audited if available) for the prior three years, including footnotes;
3. the most recent appraisals of any of the debtor's material assets (including valuations of business enterprise or equity); and
4. to the extent shared with pre-petition creditors and existing or potential purchasers, all business plans or projections prepared within the past two years.[48]

The Commission observes that providing the VIP—subject to the need to protect a debtor's confidential and proprietary information—would allow parties to make better-informed decisions regarding the impact of the debtor's intentions and facilitate more meaningful discussions about reorganization options early in the case.[49] While helpful, the VIP falls far short of the type and extent of disclosures most courts require in a disclosure statement describing a plan.

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[45] *Id.* at 201.
[46] *Id.* at 45.
[47] *Id.* at 46.
[48] *Id.* at 45.
[49] *Id.* at 46-47.

Sharing Value with the Junior Creditors: Redemption Option Value

In many cases, the liens of the senior lender fully encumber all of the assets of the debtor allowing the lender to effectively control the case by exerting leverage in connection with the terms of essential DIP financing. Lenders frequently use the terms of the financing order to force a sale of the enterprise and thereby crystalize the debtor's value on the date of closing. Because the sale usually occurs at the nadir of the debtor's economic life, this usually results in the junior classes of creditors receiving little or nothing. The senior lender benefits by a process which maximizes the going concern value of its collateral, allowing it to recover an optimal amount while avoiding the risks of funding a protracted Chapter 11 case. If the entity succeeds post-sale, the economic benefits accrue to the buyer and not to the creditors. Although the US Trustee and the Committee often attempt to negotiate a carve-out to be paid to junior creditors from the proceeds otherwise payable to the senior lender, this practice is *ad hoc* and varies greatly among jurisdictions.

Recognizing the current reality, the Commission recommends a process that would require the court to determine the future value of the enterprise.[50] Depending on the magnitude of the senior lender's deficiency claim, this would allow junior creditors to have at least the possibility of sharing in the proceeds of the sale. The Commission recommends that Section 363x sales not be approved—and plans of reorganizations not be confirmed—unless the class of creditors most junior to the fulcrum security class (e.g., the most junior class receiving a meaningful distribution in connection with sale) receive reorganization value attributable to the sale equal to what the Commission calls the redemption option value (ROV). The ROV is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the "redemption price." Redemption price is defined as an amount equal to the claims of the senior class, including any deficiency claim, plus interest at the non-default rate and allowable fees and expenses. The redemption period commences on the date of the Section 363x sale order and expires on the third anniversary of the petition date. The ROV would be determined by the court based upon evidence presented by the parties, including generally accepted market based valuation models, including the Black-Scholes option pricing model,[51] using

[50] *Id.* at 207-210.

[51] One formulation of the Black-Scholes Option Pricing Model follows:
The original formula for calculating the theoretical option price (OP) is as follows:

$$OP = SN(d_1) - Xe^{-rt}N(d_2)$$

Where:

$$d_1 = \frac{\ln\left(\frac{S}{X}\right) + \left(r + \frac{v^2}{2}\right)t}{v\sqrt{t}}$$

$$d_2 = d_1 - v\sqrt{t}$$

The variables are:

S = stock price
X = strike price
t = time remaining until expiration, expressed as a percent of a year
r = current continuously compounded risk-free interest rate
v = annual volatility of stock price (the standard deviation of the short-term returns over one year).
ln = natural logarithm
N(x) = standard normal cumulative distribution function
e = the exponential function

reasonable assumptions based upon the facts of the case. The form of consideration paid to the junior class would be determined by the senior class giving up the value, and could be paid in cash, debt, stock, warrants, or other consideration. The Commission recognizes that if the senior class is materially underwater and has a significant deficiency claim, there may be no ROV available to share with the junior class. Conversely, the closer the senior class is to being "in the money," the more likely it would be that the junior class would be entitled to ROV. The concept of ROV would not apply in the small and medium-sized enterprise cases, which are discussed below.[52]

Introducing the concept of ROV attempts to solve the problem of fixing enterprise value at a point in time when that value may be at its lowest, to the detriment of junior creditors. However, while the concept may be relatively easy to apply in cases where the debtor has a simple capital structure, the Commission acknowledges that the concept will be much harder for courts to grapple with when the debtor's capital structure is complex.[53] The concept of ROV has been criticized as an inappropriate tax or statutory carve-out imposed upon the senior class of creditors which diverts value from the senior class to the junior class in violation of the absolute priority rule.[54] More significantly, the determination of the appropriate assumptions to apply and the complexity of calculating ROV is likely to generate significant litigation which will increase the costs and the time required to approve a Section 363x sale. This may be a significant shortcoming where debtor value is eroding quickly.[55] The Commission submits that the application of ROV would likely encourage consensual resolution for the benefit of all.[56] While complex, the ROV concept attempts to provide guidelines which codify the junior class of creditors' right to potentially share in a distribution.

Sharing Value with Creditors: Precluding Code Section 506(c) Waivers

Code Section 506(c) allows a trustee to surcharge the collateral of senior lenders for the reasonable costs of preserving or disposing of the collateral. In Chapter 11 cases today, senior lenders often use their negotiating leverage to compel the estate to waive any claims that it might have under Code Section 506(c). This occurs despite the fact that senior lenders benefit greatly from using the Chapter 11 case and Code Section 363 to significantly enhance their outcomes on a cost beneficial basis. If the Code Section 506(c) waiver is given, constituent parties with little or no bargaining leverage often are left with attempting to negotiate a carve-out from the sale proceeds to fund administrative expenses and other "burial costs" of the case. While many courts are sympathetic, carve-outs are implemented on an *ad hoc* basis and vary greatly among the respective jurisdictions.

The Commission recommends that the estate not be permitted to waive its rights under Code Section 506(c).[57] The Commission would retain the requirement that to be allowed, any surcharge be

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See Hoadley Trading & investment Tools, http://www.hoadley.net/options/bs.htm (last visited November 12, 2015).

[52] American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations*, at 207-210.

[53] *Id.* at 219-220.

[54] The Commission determined that ROV should be paid by the estate (from the proceeds due to the senior lender) and not by the purchaser. *See id.* at 224. This may be a distinction without a difference. Purchasers would likely set their price taking into account the ROV resulting in the net proceeds received by the senior lender remaining the same.

[55] A court could approve the sale and escrow the sale proceeds until the ROV is determined; however, junior classes may object as this reduces their bargaining leverage, and would not be possible if the senior lender credit bid its indebtedness.

[56] *Id.*

[57] *Id.* at 226.

shown to be "reasonable" and "necessary,"[58] and it also would limit Code Section 506(c)'s application to collateral securing pre-petition debt and not apply it to collateral securing new post-petition indebtedness.[59] The Commission believes that consensual carve-outs should still be permissible, but that carve-outs should be utilized in conjunction with and not to the exclusion of surcharges under Code Section 506(c).[60]

The Problem of Small and Medium Enterprise Cases

The Commission concludes that Chapter 11 simply does not work for small to medium-sized commercial debtors.[61] The administrative costs of a protracted Chapter 11 case often doom any prospect of any successful reorganization. Congress recognized this and attempted to provide a solution in the 1994 amendments to the Code by enacting provisions relating to a small business Chapter 11 case.[62] These provisions mandate that a debtor with debts of below $2.491 million pursue a fast track case, and, among other things, allows a debtor to combine the hearing on approval of the disclosure statement with confirmation of the plan.[63] The plan in a small business case must to be confirmed within forty-five days from the date it is filed.[64] The Commission concludes that, notwithstanding these provisions—or perhaps because of mandatory time within which to confirm a plan—most small and medium-sized debtors fail.[65] Consequently, today many small debtors elect to utilize state and federal law receiverships to sell their assets.[66] Receiverships are far less time-consuming and costly than Chapter 11 cases. However, the Commission notes that receiverships are sub-par alternatives because of the inconsistency of case law, the debate about the ability to sell assets free and clear of liens, claims and encumbrances, and the fact that nonconsenting creditors may not be bound by the purported sale.[67]

The Commission's proposal is to delete the references in the Code to a small business debtor and replace them with the concept of small to medium-sized enterprises ("SME"). The SME designation would apply to businesses with no publically traded securities having less than $10 million in assets or liabilities, on a consolidated basis. In addition, an entity without publically-traded securities having assets or liabilities of more than $10 million but less than $50 million on a consolidated basis could move the court to be treated as an SME so long as the motion was filed with the petition or within seven days after the entry of the order for relief in an involuntary case. The Commission recommends that the court grant the motion if it is timely filed and is found to be in the best interests of the estate.[68]

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[58] *Id.* at 229.
[59] *Id.* at 226.
[60] *Id.* at 230.
[61] *Id.* at 283.
[62] *See* § 101(51D) of the Code.
[63] *Id.* §§ 1121; 1125; 1102(a).
[64] *Id.* §§ 1121; 1129(e).
[65] American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations*, at 281.
[66] *See, for example,* Wis. Stat. ch. 128; Fla. Stat. ch. 727.
[67] American Bankruptcy Institute, *Commission to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations*, at 283.
[68] *Id.* at 279.

If a debtor satisfies the definition of an SME or is designated as an SME, no creditors committee will be appointed in the case.[69] In addition, the Court for good cause shown, may permit an SME to use good faith estimates in compiling its VIP if audited or unaudited financial statements are unavailable.[70] Within sixty days of the entry of the order for relief, an SME is required to file a timeline for filing and soliciting acceptances to a plan. Upon filing the timeline, the court would set deadlines governing the debtor SME's plan process. The exclusive period for filing a plan under Code Section 1121 would apply.[71] Finally, the court *sua sponte*, the US Trustee, the debtor in possession or a party in interest could request that the court appoint an "estate neutral" to advise the debtor on financial and operational issues and to assist in negotiating a plan.[72] The estate neutral, who with his advisors would be paid by the estate, is akin to an examiner with expanded powers appointed under the Code. (The Commission would eliminate the concept of an examiner.) [73] The estate neutral's duties in a SME case could include providing financial and operational assistance to a SME debtor which may not have sufficient in-house resources, and assisting in the development and negotiation of a plan.[74]

The plan in an SME case would provide for payment of administrative claims in full and payment of secured and unsecured claims in accordance with the plan if accepted, or pursuant the cram down rules of Code Section 1129(b) if not accepted—subject to the SME equity retention provisions discussed below. The claims of under secured creditors would be bifurcated into allowed secured and unsecured in accordance with Code Section 506 of the Code. Elections under Code Section 1111(b) by under secured creditors to be treated as fully secured creditors would not be permitted.[75]

In an SME case, the Commission would modify the absolute priority rule to permit equity interest holders to retain an ownership interest in the reorganized debtor, notwithstanding the rejection of the plan by a class of unsecured creditors. A plan providing for equity holders to retain their interests could be confirmed despite unsecured creditor rejection if the following provisions are included:

- The pre-petition equity security holders must continue to support the debtor by remaining involved on a basis reasonably comparable to their involvement on a prepetition basis.
- No less frequently than annually, the debtor must pay the holders of unsecured claims the debtor's excess cash flow for a period of three full fiscal years following the effective date of the plan.
- The equity security holders will receive or retain 100 percent of the common stock of the debtor entitling them to receive 15 percent of the economic distributions from the reorganized debtor, including dividends and liquidation or sale proceeds.

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[69] *Id.* at 291.
[70] *Id.* 289.
[71] *Id.* at 294. Under Code Section 1121, only the debtor in possession may file a plan within the first 120 days after the entry of the order for relief. This period may be extended for not more than 18 months after entry of the order for relief.
[72] *Id.* at 291.
[73] *Id.* at 32.
[74] *Id.* at 293-294.
[75] *Id.* at 296. Code Section 1111(b) allows a secured creditor to elect to have its claim treated in a plan as fully secured and be paid the face amount of the claim over time with value of the stream of payments equal to the present value of the creditor's interest in the collateral.

- The unsecured creditors will receive 100 percent of the preferred stock of the debtor entitling them to vote on extraordinary transactions—dividends, mergers, sales of substantially all of the assets, change in charter documents, etc.—and to receive 85 percent of any economic distributions from the reorganized debtor.
- On the fourth anniversary of the effective date of the plan, the preferred stock would be converted into common stock, unless redeemed in cash on or before such date for 100 percent of the face amount of the claims held by the unsecured creditors, with a credit for any distributions the unsecured creditors received previously.[76]

The Commission believes that allowing the court to set deadlines for confirmation of the SME's plan after reviewing the debtor's timeline for proposing a plan will produce better outcomes than the mandatory deadlines currently established by the Code.[77] In addition, it concludes that four years is an appropriate period within which to permit the debtor to pay its unsecured claimants in full, especially in light of the incentive that doing so would allow the equity interest holders to retain 100 percent of the equity interests in the reorganized enterprise.[78] Eliminating the economic burden of a Committee should make it more likely that a debtor will have the resources to confirm a plan. Finally, providing for the assistance of an estate neutral may significantly enhance the prospect that more SME cases will conclude successfully.[79] However, the cost of an estate neutral and his professionals could be substantial.

These recommendations are geared toward making Chapter 11 a viable option for small and medium-size enterprises. The $10 million limitation is significantly greater than $2.491 million cap for current small business debtors, and the availability of SME designation for debtors with assets and liabilities of less than $50 million expands the benefits to many more enterprises. The modification of the absolute priority rule may make SME designation particularly attractive; however, senior lenders with large deficiency claims may make the objective of paying unsecured creditors in full within four years not feasible. More importantly, these lenders may use the debtor's inability to obtain alternative DIP financing to push the debtor towards a Section 363 sale or a less costly state court receivership.

Conclusion

The ways parties use Chapter 11 have changed significantly from the process Congress envisioned when it enacted the Code in 1978. Confirmation of a plan of reorganization is no longer the objective of the majority of Chapter 11 cases filed today. The excessive leverage of today's distressed companies has given senior lenders the ability to push for the certain outcome of a quick sale, allowing the senior lender to avoid funding a protracted and expensive case. However, sales are often done quickly with minimal input from junior classes of creditors who have few Chapter 11 plan protections and receive little or nothing from the sale process. Consequently, unsecured creditors with weak bargaining leverage—who at the Code's inception could share in the future profits of a reorganized debtor—are left to negotiate a consensual carve-out from the sale proceeds to receive any distribution from the case.

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[76] *Id.* at 297-298.
[77] *Id.* at 295.
[78] *Id.* at 302.
[79] *Id.* at 291-294.

Recognizing that it is unlikely that the clock can be turned back (or that it should be), the ABI Commission on Chapter 11 proposes changes which, among other things, attempt to slow down the timetable for asset sales to allow greater creditor evaluation and input. With the concept of ROV, the Commission would provide for a mechanism that affords junior classes of creditors at least the possibility of a distribution based upon the future prospects of the debtor. By precluding Code Section 506(c) waivers, the Commission intends to strengthen a debtor's hand in ensuring that a secured creditor cannot use the Chapter 11 process to maximize its recovery without paying for the privilege. The proposed reforms also provide for VIPs to ensure that creditors will have basic financial information early in the case essential to making informed decisions. In addition, the Commission proposes provisions applicable to small and medium-sized debtors designed to enhance the likelihood that these debtors can reorganize successfully with equity owners retaining at least a portion of their equity interests. It is unclear if any of these proposals will be enacted, especially in the current gridlocked political environment; however, the Commission has thoughtfully attempted to recognize the realities of Chapter 11 as it is utilized today, and its Report provides at least a glimpse into what Chapter 11 practice may become in the future.

Key Takeaways

- .Courts around the country recognize that given the capital structure of a majority of debtor companies today, a Code Section 363 sale may be the only pathway to preserve a going concern business and allow unsecured creditors some prospect for a recovery.
- The legal standard to authorize such sales has evolved in light of this reality. The holding in *White Motors* that a sale of all of debtor's assets is not allowed outside of a plan has given way to courts applying the liberal standards articulated in *General Motors* and *Chrysler* to authorize such sales on foreshortened time frames.
- The ABI Commission recognizes the importance of sales of substantially all of a debtor's assets in its recommendations relating to 363x sales. Many of these recommendations try to import into the sale process the protections that plans of reorganizations and the plan process afford creditors (e. g. enhanced information, expanded time frames and the potential for creditors to have some opportunity to realize value from the sale).
- The ABI Commission also recognizes that Chapter 11 is too costly and consequently does not work for small to medium size enterprises. The Commission's SME recommendations are designed to change this dynamic.
- It is unclear whether the ABI Commission's recommendations will become law anytime soon. However, bankruptcy judges around the country are taking note of the Commission's recommendations. To the extent judges begin to implement some of the recommendations even in the absence of legislation, the ABI Commission's Report is required reading for all bankruptcy practitioners.