GENERAL ISSUES IN CHAPTER 11

The Chapter 11 Working Group investigated issues that arise in general business cases. The Working Group engaged in a continuous process of canvassing secured creditor representatives, a variety of unsecured creditors representatives, debtors' representatives, businesspeople, investment analysts, economists, legal scholars, judges, trustees, and any other interested parties. The issues derived through that process were then developed throughout the Commission's deliberations. The Recommendations set forth by the Chapter 11 Working Group and adopted by the Commission are aimed at enhancing the return and lowering the costs for many different types of creditors while embracing the basic goal in Chapter 11 to promote reorganizations.

Many of the following Recommendations would resolve open legal questions that frequently cause litigation and delay. Clarification will minimize the time and money lost to repeated judicial disputes over issues such as the rules governing classification of claims, court review of creditors' committee appointments, and the permissibility of releasing claims against nondebtor parties. Because bankruptcy laws provide a backdrop for a broad range of out of court negotiations, increased certainty enhances the opportunities for out of court workouts.

The Working Group also developed recommendations that affirmatively would promote speed and efficiency within the current reorganization structure. Some recommendations, such as those to facilitate prepackaged bankruptcies and to authorize local mediation programs, should further these goals directly. Others promote those values indirectly, such as the Recommendation to promote sales of assets in Chapter 11 cases.

To maintain the balance in the business bankruptcy system, it also is important to consider whether the costs of business bankruptcy are borne disproportionately by certain groups. While discussions of bankruptcy often are polarized into "debtor" versus "creditor" debates, a more delicate balance must be struck among the members of the diverse creditor body. Whether the debtor seeks to reorganize or liquidate, the Bankruptcy Code must reconcile competing needs of secured lenders, unsecured lenders, trade suppliers, employees, utility providers, independent contractors, lessors, lessees, other contract creditors, taxing authorities, warranty holders, tort victims, and infinite other types of claimants. Although the priority of payment is relatively clear in the statute, a wide variety of other questions can have significant distributional implications. Instead of addressing this concern with a series of amendments directed at discrete groups of creditors to the exclusion of others, the Chapter 11 Working Group, as well as other working groups, attempted to make moderate adjustments to the current system to enhance the system's fairness.

RECOMMENDATIONS

2.4.1 *Clarifying the Meaning of "Rejection"*

The concept of "rejection" in section 365 should be replaced with "election to breach."

Section 365 should provide that a trustee's ability to elect to breach a contract of the debtor is not an avoiding power.

Section 502(g) should be amended to provide that a claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

2.4.2 *Clarifying the Option of "Assumption"*

"Assumption" should be replaced with "election to perform" in section 365.

2.4.3 *Interim Protection and Obligations of Nondebtor Parties*

A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract if such nondebtor party was acting in accordance with a court order governing temporary performance.

2.4.4 *Contracts Subject to Section 365; Eliminating the "Executory" Requirement*

Title 11 should be amended to delete all references to "executory" in section 365 and related provisions, and "executoriness" should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.

2.4.5 *Prebankruptcy Waivers of Bankruptcy Code Provisions*

Section 558 of the Bankruptcy Code should provide that except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11. Any issue actually litigated or any issue resolved by consensual agreement between the debtor and a governmental unit in its police or regulatory capacity, whether embodied in a judgment, administrative order or settlement agreement, would be given preclusive effect.

2.4.6 *Prepackaged Plans of Reorganization; Section 341 Meeting of Creditors*

Section 341 should provide that upon the motion of any party in interest in a Chapter 11 case that entails a prepackaged plan of reorganization, the court may waive the requirement that the U.S. trustee convene a meeting of creditors.

2.4.7 *Authorization for Local Mediation Programs*

Congress should authorize judicial districts to enact local rules establishing mediation programs in which the court may order non-binding, confidential mediation upon its own motion or upon the motion of any party in interest. The court should be able to order mediation in an adversary proceeding, contested matter, or otherwise in a bankruptcy case, except that the court may not order mediation of a dispute arising in connection with the retention or payment of professionals or in connection with a motion for contempt, sanctions, or other judicial disciplinary matters. The court should have explicit statutory authority to approve the payment of persons performing mediation functions pursuant to the local rules of that district's mediation program who satisfy the training requirements or standards set by the local rules of that district. The statute should provide further that the details of such

mediation programs that are not provided herein may be determined by local rule.

2.4.8 *Court Review of Appointments to Creditors' Committees*

Subsection (a)(2) of 11 U.S.C. § 1102, "Creditors' and equity security holders' committees," should be amended to read as follows:

> **(2) On request of a party in interest and after notice and a hearing, the court may order a change in membership of a committee appointed under subsection (a) of this section if necessary to ensure adequate representation of creditors or of equity security holders. On request of a party in interest, the court may order the appointment of additional committees of creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States Trustee shall appoint any such committee.**

2.4.9 *Employee Participation in Bankruptcy Cases*

Changes to the Official Forms, the U.S. Trustee program guidelines and the Federal Rules of Bankruptcy Procedure, are recommended to the Administrative Office of the U.S. Courts, the Executive Office of the U.S. Trustee, and the Advisory Committee on Bankruptcy Rules of the Judicial Conference, as appropriate, in order to improve identification of employment-related obligations and facilitate the participation by employee representatives in bankruptcy cases. The Official Forms for the bankruptcy petition, list of largest creditors, and/or schedules of liabilities should solicit more specific information regarding employee obligations. The U.S. Trustee program guidelines for the formation of creditors' committees should be amended to provide better guidance regarding employee and benefit fund claims. The appointment of employee creditors' committees should be encouraged in appropriate circumstances as a mechanism to resolve claims and other matters affecting the employees in a Chapter 11 case.

2.4.10 *Enhancing the Efficacy of Examiners and Limiting the Grounds for Appointment of Examiners in Chapter 11 Cases*

Congress should amend section 327 to provide for the retention of professionals by examiners for cause under the same standards that govern the retention of other professionals.

The Advisory Committee on Bankruptcy Rules of the Judicial Conference should consider a recommendation that Federal Rule of Bankruptcy Procedure 2004(a) be amended to provide that "On motion of any party in interest or of an examiner appointed under section 1104 of title 11, the court may order the examination of any entity."

Congress should eliminate section 1104(c)(2), which requires the court to order appointment of an examiner upon the request of a party in interest if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes or owing to an insider, exceed $5,000,000.

2.4.11 ***Valuation***

A creditor's secured claim in personal property should be determined by the property's wholesale price.

A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

2.4.12 ***Clarifying The Conditions for Sales Free & Clear Under 11 U.S.C. § 363(f)***

Congress should make clear that bankruptcy courts can authorize sales of property of the estate free of creditors' interests regardless of the relationship between the face amount of any liens and the value of the property sold.

2.4.13 ***Release of Claims Against Nondebtor Parties***

Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.

2.4.14 ***Exclusion of Payroll Deductions from Property of the Estate***

Congress should amend 11 U.S.C. § 541(b) to clarify that funds deducted from paid wages within 180 days prior to the date of the commencement of a case under title 11, held by a debtor/employer, and owed by employees to third parties, other than a federal, state or local taxing authority, do not fall within the definition of "property of the estate."

2.4.15 *Absolute Priority and Exclusivity*

11 U.S.C. § 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase new interests in the reorganized debtor.

11 U.S.C. § 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in section 1129(b)(2)(B)(i).

2.4.16 *Classification of Claims*

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can demonstrate that the classification is supported by a "rational business justification."

2.4.17 *Prepetition Solicitation for a Prepackaged Plan of Reorganization*

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by an entity that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If an entity solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if the entity does not complete an exchange offer or any other transaction on the basis of such solicitation.

2.4.18 *Postpetition Solicitation for a Prepackaged Plan of Reorganization*

Section 1125(b) should be amended to provide that the acceptance or rejection of a plan may be solicited after the commencement of a case under title 11 but before the court approves a written disclosure statement from those classes that were solicited for the plan prior to the filing of the bankruptcy petition.

2.4.19 *Elimination of Prohibition on Nonvoting Equity Securities*

Congress should amend section 1123(a)(6) to eliminate the requirement that the charter of the reorganized corporate debtor prohibit the issuance of nonvoting equity securities. Section 1123(a)(6) should otherwise remain unchanged.

2.4.20 *Postconfirmation Plan Modification*

11 U.S.C. § 1127(b) should be amended to permit modification after confirmation of a plan until the later of 1) substantial consummation or 2) two years after the date on which the order of confirmation is entered. All other restrictions on postconfirmation plan modification in section 1127(b) should remain unaltered.

DISCUSSION

I. Issues Arising During a Chapter 11 Case

Section 365

The filing of a bankruptcy petition triggers the creation of an estate encompassing all of the debtor's property interests, including contractual rights. Unlike many other types of property that come into the estate, contracts involve both rights and duties. Therefore, the treatment of contracts in bankruptcy raises more complicated questions. Whether a contract will enhance or diminish the value of the estate entails an analysis similar to that undertaken by any contracting party outside of bankruptcy. Yet, any such decisions made by a debtor in possession or trustee, both of whom act as fiduciaries to the bankruptcy estate, must be closely monitored by creditors and the court. Section 365, which establishes the rules for this procedure, is, therefore, a critically important provision that should provide clear guidance for the fair and uniform treatment of these obligations. The need for guidance is particularly crucial given the fact that almost every debtor in the bankruptcy system is a party to numerous contracts and leases.

The countless types of contracts and number of circumstances have complicated attainment of the goal of establishing clear and uniform rules. In an attempt to address discrete situations, section 365 has been amended repeatedly over the past twenty years and now spans over thirteen pages in a typical version of the Bankruptcy Code. These additions to section 365 may have abrogated questionable case law interpretations, and have offered pockets of certainty for some industries or types of contracts, but they have not resolved fundamental ambiguities that should be addressed generically.[1113] Therefore, instead of undertaking a piecemeal analysis of each subsection of section 365, the Commission reviewed the larger conceptual issues inherent in section 365 to eliminate confusion on a more global basis.

2.4.1 *Clarifying the Meaning of "Rejection"*

The concept of "rejection" in Section 365 should be replaced with "election to breach."

[1113] "The [Judiciary] Committee believes that continued creation of special interest exceptions to section 365 is not desirable, and intends to revisit section 365 so that it is, in Mr. [George] Hahn's words, a 'total cohesive section.'" H.R. REP. NO. 100-1012, at 3 (1988).

Section 365 should provide that a trustee's ability to elect to breach a contract of the debtor is not an avoiding power.

Section 502(g) should be amended to provide that a claim arising from the election to breach shall be allowed or disallowed the same as if such claim had arisen before the date of the filing of the petition.

Section 365 permits a debtor in possession or trustee to elect to "reject" a contract entered prepetition, subject to court approval. The term "rejection" has no obvious state contract law counterpart. Although the Bankruptcy Code provides that rejection should be treated as a breach,[1114] the Code does not state expressly that rejection is synonymous with breach, nor does it fully delineate the consequences of a trustee's decision to reject. Not surprisingly, the concept of rejection has been applied inconsistently by the courts, and has led to the numerous special interest amendments to section 365.

The Commission recommends a common-sense clarification of the term "rejection" by replacing it with "election to breach." The Commission further recommends that the Bankruptcy Code delineate the consequences of electing to breach to correct on a generic basis the contrary results reached by some courts.[1115] The bankruptcy trustee's election not to perform a contract is nothing more or less than a breach of the contract and should be treated accordingly.[1116] Rejection does

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[1114] *See* 11 U.S.C. § 365(g) (1994) (rejection of contract or lease constitutes breach), 11 U.S.C. § 502(g) (1994) (claim arising from rejection shall be determined as if claim had arisen prepetition).

[1115] *See, e.g.*, Lubrizol Enters., Inc. v. Richmond Finishers, 756 F.2d 1043 (4th Cir. 1985), *cert. denied*, 475 U.S. 1057 (1986); *In re* Gillis, 92 B.R. 461, 465 (Bankr. D. Haw. 1988) (rejection terminates lease and extinguishes corresponding security interest in leasehold), *citing In re* Southwest Aircraft Servs. Inc., 66 B.R. 121 (Bankr. 9th Cir.), *rev'd on other grounds*, 831 F.2d 848 (9th Cir. 1988); *In re* Giles Assoc., Ltd., 92 B.R. 695 (Bankr. W.D. Tex. 1988) (Section 365(d)(4) terminates lease as to all parties, including creditors); Chatlos Sys., Inc. v. Kaplan, 147 B.R. 96 (D. Del. 1992), *aff'd without opinion*, 998 F.2d 1005 (3d Cir. 1993). "[I]f the . . . agreement is a real property lease, then upon rejection, the lessee . . . may be able to retain possession pursuant to section 365(h), a protection that is not available in the event of a rejection of any other type of executory contract such as a management agreement." *In re* Dunes Hotel Assoc., 194 B.R. 967, 987 (Bankr. D.S.C. 1995). *See also In re* Firstcorp, Inc., 973 F.2d 243, 246 (4th Cir. 1992) (Section 365(o) prevents "trustee from rejecting any such commitment as an executory contract under his usual 'avoidance' powers" pursuant to 11 U.S.C. § 365(a)).

[1116] Medical Malpractice Ins. Assoc. v. Hirsch (*In re* Lavigne), 114 F.3d 379, 386 (2d Cir. 1997) (rejection of debtor's executory contract constitutes breach of contract and does not terminate contract); *In re* Austin Dev. Co., 19 F.3d 1077, 1081 (5th Cir.) (rejection means breach, not termination), *cert. denied*, 513 U.S. 874 (1994), *citing In re* Continental Airlines, 981 F.2d 1450, 1459 (5th Cir.1993) ("to assert that a contract effectively does not exist as of the date of rejection is inconsistent with deeming the same contract breached"); *In re* Modern Textile, Inc., 900 F.2d 1184, not "nullify," "rescind," or "vaporize" the contract or terminate the rights of the parties; it does not serve as an avoiding power separate and apart from the express avoiding powers already provided in the Bankruptcy Code.[1117] For example, if a debtor entered a contract prepetition and conferred rights in an asset to a nondebtor party, a trustee would not be entitled to repudiate the transfer and retrieve the property unless one of the other avoiding powers—not section 365—permitted it to do so. Under most circumstances, this means that the nondebtor party would be entitled to a claim for money damages, and the contract obligations themselves would be discharged.[1118] The claim would be paid in the bankruptcy *pro rata* with other unsecured creditors.

With a few important exceptions, bankruptcy law accepts the nonbankruptcy substantive law applicable to a contract,[1119] but bankruptcy adjusts the form of the remedies available upon breach. Damages may be calculated under state law, but they are paid out according to bankruptcy priorities and principles. Specific performance may be available under state law, but it is rarely permitted against the trustee. Thus, state contract law generally defines a party's rights, while federal bankruptcy law determines how those rights are enforced in a bankruptcy case. The most important

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1191 (8th Cir. 1990); *In re* Taylor, 913 F.2d 102, 106-07 (3d Cir. 1990) (rejection leaves the nondebtor with claim against estate just as would breach in nonbankruptcy context); Leasing Serv. Corp. v. First Tennessee Bank, Nat'l Ass'n, 826 F.2d 434, 436-37 (6th Cir. 1987). This interpretation has been endorsed by numerous commentators. *See, e.g.*, REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 125 (rev. ed. 1997) (term rejection should be eliminated and law should be clarified such that decision not to perform is considered breach); Morris Shanker, *A Proposed New Executory Contract Statute*, 1993 ANN. SUR. BANKR. L., 129; Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989); Michael T. Andrew, *Executory Contracts in Bankruptcy, Understanding Rejection*, 59 U. Colo. L. Rev. 845 (1988); THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW (1986).

[1117] Of course, otherwise-applicable bankruptcy avoiding powers might provide a basis for avoiding the contract. *See* 11 U.S.C. § 548 (1994) (fraudulent conveyances), 11 U.S.C. § 544 (1994) (trustee's "strong arm" power to avoid), 11 U.S.C. § 547 (1994) (avoiding preferential payments). Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991).

[1118] "Rejection avoids specific performance, but the debtor assumes a financial obligation equivalent to damages for breach of contract." Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equip. Corp., 54 F.3d 406, 407 (7th Cir. 1995), *citing* NLRB v. Bildisco & Bildisco, 465 U.S. 513, 531 (1984), and DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 117-27 (rev. ed. 1993). *Cf. In re* Udell, 18 F.3d 403 (7th Cir. 1994) (reversing district court holding that covenant not to compete was dischargeable "claim" entitled to pro rata distribution).

[1119] Butner v. United States, 440 U.S. 48, 54 (1979) (Congress generally lets state law determine property rights in assets of debtor's estate).

example, which is the choice between damages and specific performance, has powerful distributional consequences and must be governed by a uniform policy in a bankruptcy case;[1120] otherwise, state laws providing very broad rights to specific performance would have the inequitable effect of granting preferential treatment to certain contract creditors, to the detriment of all other general unsecured creditors in bankruptcy.[1121]

The recommended clarifications should prevent the contrary results reached by some courts without requiring enactment of additional special interest legislation in response to each individual case. It would make it clear that the impact of electing to breach under section 365 is limited to the consequences of breach under state law, subject to the limitations on remedies imposed by the Code.

Competing Considerations. Some would argue that a trustee or debtor in possession should be able to avoid or rescind a contract in bankruptcy whenever it would be helpful to a reorganization to do so.[1122] For example, if the debtor is a lessor of copy machines, avoidance of all leases might permit the debtor in possession to sell the machines in bulk, rather than selling only lease residuals. However, this would enable the debtor in bankruptcy to make contracts disappear—a power that is very different from a simple breach of contract for which the debtor would incur damages. If a debtor were empowered to demand possession of property from a third party, the bankruptcy process would readjust the bargains struck at state law, rather than simply determine a claim for breach. To permit the trustee or debtor in

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[1120] *See id.* at 55 (recognizing that federal interest sometimes requires different result than what state law would provide). "Rejection avoids specific performance, but the debtor assumes a financial obligation equivalent to damages for breach of contract." Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equip. Corp., 54 F.3d 406, 407 (7th Cir. 1995), *citing* DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 117-27 (rev. ed. 1993). *In re* Fleishman, 138 B.R. 641, 648 (Bankr. D. Mass. 1992) ("Specific performance should not be permitted where the remedy would in effect do what section 365 meant to avoid, that is, impose burdensome contracts on the debtor."); *In re* A.J. Lane & Co., 107 B.R. 435, 439 (determining that the right of specific performance is subordinate to the debtor's rejection rights); *In re* Waldron, 36 B.R. 633, 642 n.4 (Bankr. S.D. Fla. 1984) ("Code does not permit specific performance as a remedy resulting from the rejection of an executory contract under section 365"), rev'd on other grounds, 785 F.2d 936 (11th Cir.1986). *But see In re* Solokoff, 200 B.R. 300, 301 (Bankr. E.D. Pa. 1996) (possibility of specific performance for rejection determined by state law rights); *In re* West Chestnut Realty of Haverford Inc., 177 B.R. 501 (Bankr. E.D. Pa. 1995) (if permitted under applicable state law, nondebtor party to rejected executory contract may be able to obtain specific performance).

[1121] *See, e.g., In re* TransAmerican Natural Gas Corp., 79 B.R. 663, 667 (Bankr. S.D. Tex. 1987) (rejected contract effectively would be enforced if court enforced liquidated damages clause).

[1122] Conversely, other commentators have argued that breaching and paying pro rata damages on contracts that are value-enhancing overall (when considering value to the nondebtor as well) may yield economic inefficiency. *See* Jesse M. Fried, *Executory Contracts and Performance Decisions*, 46 DUKE L.J. 517 (1996).

possession to undo valid contracts whenever the estate might benefit would introduce a great deal of uncertainty into private bargaining and might lead to abuse.

There is some concern that adjusting the lexicon of section 365 could encourage additional litigation. However, using the word "breach" incorporates a term from state law contract principles with which courts already are familiar. It is likely to diminish rather than increase confusion. Rejection, a concept with no state law contract analogue, has been problematic. The special interest amendments to section 365 reflect an attempt to work around the notion of a breach as a repudiation or avoidance power, consistent with this Proposal. The proposed change is intended to harmonize both the term used and the concept involved in determining what a trustee may do if a contract is not to be performed.

Finally, this Proposal might be criticized as being inadequately remedial since it stops short of dismantling the special interest provisions presently in section 365. Some might take issue with the more conservative approach used by the Commission on the basis that section 365 will remain too complicated even with these changes. More importantly, the proposed changes call into question the interpretation of the complicated, industry-specific provisions that remain in section 365. By negative implication, legislation devoted to only one type of contract undercuts the general applicability of the principles it expresses. Establishing a general rule that is consistent with the principles of the special interest legislation without eliminating the special interest legislation may cause courts to place a more limited interpretation on either the general or the limited rule. It is Congress' prerogative to consider whether this package of amendments vitiates the need for several of the subsections of section 365 that apply only to one type of industry or contract.

2.4.2 *Clarifying the Option of "Assumption"*

"Assumption" should be replaced with "election to perform" in Section 365.

Court approval of a trustee's request to assume a contract is a significant event. Once a debtor in possession or trustee has assumed a contract, the bankruptcy estate becomes obligated to perform or to find an adequate replacement to perform through its right to assign. Any failure to do so will result in an administrative priority claim for damages that must be paid ahead of all other general creditors,[1123] as opposed to the *pro rata* distribution that is received by a party to a breached contract. This would be the case whenever a contract is assumed, even if the case later is

[1123] *See In re* Superior Toy & Mfg. Co., 78 F.3d 1169, 1172 (7th Cir. 1996); *In re* Klein Sleep Prods., 78 F.3d 18, 25 (2d Cir. 1996) (administrative expense priority of assumed contract cannot be changed by subsequent rejection).

converted to a Chapter 7 liquidation.[1124] The trustee should elect to commit the estate to perform and receive performance or transfer the contract only if such actions are likely to yield a net benefit to the estate, *i.e.*, the value of the nondebtor party's remaining performance exceeds the estate's costs of taking over the debtor's remaining obligations.[1125]

Due to the confusion already inherent in section 365, the Commission believes that it is sensible to use more comprehensible terms that characterize the events they represent. By using the words "election to perform," this Proposal would introduce a concept parallel to "election to breach" and would replace problematic language with clear language. The Proposal would not change any of the implications of making this election, such as the obligation to cure and give adequate assurance of future performance under section 365(b) and the administrative priority of any prepetition or postpetition claim under the contract.

This Proposal replaces the term "assumption" with "election to perform" to clarify the meaning of the action at issue, but the Commission does not address the severability of contracts to be performed, nor does it address issues arising when a partner files for bankruptcy and the treatment of a partnership agreement, a subject discussed elsewhere in this report.[1126] This Proposal also would not alter the economic considerations preceding a trustee's election to perform or assign ("transfer").[1127] However the phrase "election to perform" is more consistent with the result intended, but not clearly expressed in section 365(c)(1),[1128] that a debtor in

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[1124] *Id.*

[1125] Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989).

[1126] For more information on this subject, please refer to the Section on Partnerships and Partners.

[1127] It may be sensible to rename assignment as transfer as well. Some commentators already have recognized that "assignment" in bankruptcy is not parallel to its state law counterparts, in that the Bankruptcy Code disregards the nonbankruptcy rule prohibiting the delegation of duties if the original obligor does not remain liable. *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155 (1989).

[1128] 11 U.S.C. § 365(c)(1) (1994) (trustee cannot assume or assign contract or lease if applicable law excuses party from accepting performance from or rendering performance to another entity).

possession stand in the shoes of a debtor and is therefore entitled to assume any prepetition contract absent some unusual public policy bar.[1129]

Competing Considerations. Once again, some might be concerned that any change in terminology will promote litigation. However, "election to perform" is a more apt analogue to "election to breach," and would provide a sensible parallel structure to section 365. The change also helps to develop the distinction between assumption by the estate and assignment to third parties, which involve different legal and policy considerations.

The election to perform and to receive performance under a personal property lease in consumer cases has caused confusion and raises special problems that are not addressed in this Proposal. Trustees may be reluctant to elect to perform these types of leases if they are concerned about taking on personal responsibility for the performance of the leases.

2.4.3 *Interim Protection and Obligations of Nondebtor Parties*

A court should be authorized to grant an order governing temporary performance and/or providing protection of the interests of the nondebtor party until the court approves a decision to perform or breach a contract.

Section 503(b) should include as an administrative expense losses reasonably and unavoidably sustained by a nondebtor party to a contract, a standard based on nonbankruptcy contract principles, pending court approval of an election to perform or breach a contract if such nondebtor party was acting in accordance with a court order governing temporary performance.

[1129] Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489, 493 (1st Cir. 1997) (ability to assume not dependent on whether contract is assignable), *cert. denied*, 117 S. Ct. 2511 (U.S. 1997); *In re* Cardinal Indus., Inc., 116 B.R. 964 (Bankr. S.D. Ohio 1990). *In re* Leroux, 69 F.3d 608, 613 (1st Cir. 1995) (postpetition debtor is not materially different legal entity from prepetition debtor for purposes of performance, breach or transfer of contracts), *citing* H.R. REP. NO. 96-1195 § 27(b) (1980) and NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984). *But see In re* West Elec. Inc., 852 F.2d 79, 83 (3d Cir. 1988) (debtor in possession cannot assume contract if applicable law precludes assignment of contract, thus section 365(c)(1) requires hypothetical assignment test); United States v. Carolina Parachute Corp., 108 B.R. 100 (M.D.N.C. 1989), *aff'd in part & vacated in part*, 907 F.2d 1469 (4th Cir. 1990); *In re* Plum Run Serv. Corp., 159 B.R. 496, 500 (Bankr. S.D. Ohio 1993); Pennsylvania Peer Review Org., Inc. v. United States, 50 B.R. 640 (Bankr. M.D. Pa. 1985). *See generally* Brett W. King, *Assuming and Assigning Executory Contracts: A History of Indeterminate "Applicable Law,"* 70 AM. BANKR. L.J. 95, 116 (1996).

The value of a contract to the bankruptcy estate and the ability of the debtor to perform the obligation often are unclear at the outset of a bankruptcy case. Even if the debtor files for bankruptcy with the express intent to reorganize, the likelihood of maintaining operations and proceeding to a successful reorganization may not be immediately apparent. In the first chaotic moments after filing, it is generally imprudent for the debtor in possession or trustee to make binding decisions to elect to perform or breach a contract or lease before parties can assess the direction of a case. Because a binding election to perform a contract makes the contractual obligation rise to the level of administrative expense priority and thus significantly affects distributions to all creditors, if the case is converted to Chapter 7 to be liquidated, a contract that the trustee has elected to perform can consume a substantial portion of the estate's assets. The contract creditor will receive a substantial preference, but there may be very little remaining for *pro rata* distribution to other unsecured creditors.[1130] Equally harmful to the estate is a precipitous election to breach a contract that might have been quite lucrative.

For these reasons, the Code does not require immediate elections to breach or performance of outstanding contracts.[1131] Although nondebtor parties can request that the debtor in possession or trustee make the election early in the case,[1132] courts are reluctant to force early decisions when the economic consequences of such decisions are not clear, even when a debtor indicates an intent to make the election.[1133] Rather, many courts prefer to defer such final decisions to plan confirmation or liquidation.

[1130] *See, e.g., In re* Klein Sleep Prods., Inc., 78 F.3d 18 (2d Cir. 1996) (even if trustee subsequently rejected upon conversion and gave property back to landlord and received no further benefit from lease, assumed contract gave rise to administrative expense priority for full amount of claim and was not subject to one-year damage cap for that type of lease).

[1131] In a Chapter 7 case, the trustee automatically has sixty days in which to make a decision regarding performance, and potentially can request more time. 11 U.S.C. § 365(d)(1) (1994). However, in other chapters the trustee may make the election at any time before plan confirmation other than with respect to leases. 11 U.S.C. § 365(d)(2).

[1132] 11 U.S.C. § 365(d)(2) (1994) (on request of party to such contract or lease, court may order trustee to determine within specified period of time whether to assume or reject such contract or lease). *But see* 11 U.S.C. § 365(d)(4) (1994) (giving trustee 60 days to make election with respect to nonresidential real property leases, in absence of court authorized extension).

[1133] *See, e.g.,* Medical Malpractice Ins. Assoc. v. Hirsch (*In re* Lavigne), 114 F.3d 379, 386 (2d Cir. 1997), *quoting In re* Orion Pictures Corp., 4 F.3d 1095, 1098 (2d Cir. 1993) (trustee is to go "through inventory of executory contracts of the debtor and decide which ones it would be beneficial to adhere to and which ones it would be beneficial to reject") *cert. dismissed*, 114 S. Ct. 1418 (1994); *In re* Gateway Apparel, Inc., 210 B.R. 567 (Bankr. E.D. Mo. 1997) (denying debtor's motion to assume and sustaining unsecured creditors' committee objection to motion to assume, because assumption would be premature and no harm to parties of deferring assumption decision).

Policy supports the deferral until the parties can assess and determine the best economic action in light of the circumstances. However, deferral has a potentially costly impact on the nondebtor party to the contract, which raises three questions: 1) Is the nondebtor party expected to prepare or continue to perform pending this election? 2) If so, will the nondebtor party be compensated for his performance? 3) How should the court determine the appropriate measure of damages? These questions should be answered in a way that increases the likelihood that decisions on contracts are not made prematurely and provides that the costs of delaying the decision will be borne by the estate and not by the nondebtor contract party.

Compelling Performance of the Nondebtor. Nothing in current bankruptcy law excuses the nondebtor party to a contract or lease from its performance obligations under the contract or lease during the "gap period" in which the debtor decides whether to breach, perform, or transfer.[1134] The Commission's Proposal would recognize explicitly that a court could order the nondebtor party to perform temporarily or prepare to perform according to the contract. Chapter 11 debtors that intend to remain in operation must be able to rely on the return performance of a nondebtor party in order to remain a going concern. If a trustee is going to sell either valuable assets or sell a Chapter 7 debtor as a going concern, a temporary performance order may be equally necessary. However, as discussed below, nothing in current bankruptcy law clearly protects the nondebtor party's right to compensation for such postbankruptcy performance.

Requirement of Compensation. The Commission recommends that the Bankruptcy Code provide express authorization for the payment of nondebtor parties that perform in accordance with temporary performance orders. The Bankruptcy Code presently does not speak directly to the issue of payment to nondebtor parties for their contractual performance, which puts parties in economic peril when they are required to perform.[1135] Section 365 requires debtor-lessees to perform on certain

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[1134] "An executory contract remains in effect pending assumption or rejection by the trustee. Thus, the trustee can enforce the contract against the nondebtor party prior to assumption or rejection." 1 GINSBERG & MARTIN ON BANKRUPTCY § 7.01[c] 7-10 (Robert E. Ginsberg et al. eds. 3d ed. 1990) (citations omitted). *See also In re* Whitcomb & Keller Mortgage Co., 715 F.2d 375 (7th Cir. 1983) (nondebtor party ordered to supply computer services to debtor prior to determination on acceptance or rejection of computer service contract).

[1135] *See, e.g., In re* Jartran, Inc., 732 F.2d 584 (7th Cir. 1984) (nondebtor party that continued to perform under contract pending assumption or rejection but did not request court order was not entitled to administrative expense claim); *see also In re* Continental Energy Assoc., 178 B.R. 405, 407 (Bankr. M.D. Pa. 1995) ("it has been less common where the courts have compelled a supplier to furnish some service or material , but there is some precedent"). The court in this case used its power under section 105 to direct the counter party to perform. Entitlement to "adequate protection" payments is questionable for interim performance obligations and regular administrative expense analysis is problematic as well. Courts also have debated whether nondebtor contract parties are entitled to adequate protection payment. *Cf. In re* Sweetwater, 40 B.R. 733 (Bankr. D. Utah leases pending assumption or rejection, but even those provisions have not guaranteed full protection for nondebtor lessors due to the time constrictions and the lack of guidance on method of calculating compensation.[1136] Sometimes courts permit a nondebtor party to receive full contract payments in the interim period, only to subject those payments to later scrutiny that may result in disgorgement.[1137] Due to the uncertain state of the law, nondebtor parties are more likely to request the court to compel the trustee or the debtor in possession to elect contract performance within a shorter period of time even if the case is not sufficiently mature to assess the effects of this decision on the estate. The Commission's Proposal would give the courts the much-needed general authorization to order payments or to develop other means to ensure that the interests of the nondebtor party to a contract are not further injured or prejudiced pending the trustee's or debtor's election and provide that compensation to the nondebtor party would be entitled to administrative expense priority.

Appropriate Measure of Damages for Postpetition Performance. Because courts have varied greatly in their approaches to determining compensation in this context, this Recommendation would be incomplete without providing additional guidance on the measure of damages. Assessing appropriate compensation and the priority of that compensation can be difficult. Proper compensation should be determined under ordinary contract principles. Whatever compensation would be awarded to the nondebtor party under similar nonbankruptcy circumstances should be its allowed administrative claim for postpetition performance or breach. The courts mistakenly have applied a special bankruptcy rule for this purpose, focusing on

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1984) (adequate protection designed to protect secured creditors), *aff'd*, 57 B.R. 743 (D. Utah 1985); *In re* DeSantis, 66 B.R. 998 (Bankr. E.D. Pa. 1986) (adequate protection is available for lessees); *but see* United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 371-72 (1988); (restrictive view of entitlement to adequate protection). *See also* 11 U.S.C. § 363(e) (amended in 1994 to include in its scope unexpired leases of personal property). *See generally* Douglas W. Bordewieck, *The Post-Petition, Pre-Rejection Pre-Assumption Status of an Executory Contract*, 59 AM. BANKR. L. J. 197 (1985) (adequate protection was designed to protect only secured creditors); Neil P. Olack, *Executory Contracts and Unexpired Leases: Right to Adequate Protection Prior to Assumption or Rejection*, 4 BANKR. DEV. J. 421 (1987); William H. Schorling & Robert P. Simons, *Adequate Protection for the Nondebtor Party to Executory Contracts and Unexpired Leases*, 64 AM. BANKR. L.J. 297 (1990); Howard C. Buschman, III, *Benefits and Burdens: Post-Petition Performance of Executory Unassumed Contracts*, 5 BANKR. DEV. J. 341 (1988).

[1136] 11 U.S.C. § 365(d)(3) (1994) requires the debtor in possession to perform its lease obligations until assumption or rejection notwithstanding Section 503(b)(1), which authorizes payment of actual and necessary estate preservation costs. *See also* 11 U.S.C. § 365(d)(10) (1994) (requiring trustee to timely perform all obligations of the debtor, except those specified in Section 365(b)(2), first arising from or after 60 days after order for relief in Chapter 11 case under personal property lease).

[1137] *In re* Continental Energy Assoc., 178 B.R. 405, 409 (Bankr. M.D. Pa. 1995).

the actual and necessary benefit to the estate, but there is no justification for ignoring ordinary contract principles to award compensation for performance or injury from performance that the estate has sought and the court has approved, whether the contract has been assumed or only ordered temporary performance. Part of the confusion arises from the general administrative expense authorization under section 507(a)(1), which uses a standard based on actual benefit to the estate.[1138] Without alternative statutory authorization for this type of situation, the courts cannot use appropriate contract principles to determine rightful compensation to the nondebtor party, and therefore sometimes reach an inappropriate result.

The Commission's Proposal would fill this gap. Compensation is designed to be remedial and to minimize the adverse consequences of a delay in the decision to breach or perform. The Proposal therefore focuses squarely on "losses reasonably and unavoidably sustained by a nondebtor party." The nondebtor party's injury is the relevant factor to determine an accurate calculation of damages. The role of the contract price in determining the nondebtor party's remedy will depend on the facts of the case, just as in any nonbankruptcy contract damage action that uses restitution or rescission. The actual injuries suffered by a nondebtor party may be affected by a variety of factors such as when the estate must begin to perform. Some examples illustrate this principle:

> A debtor has an equipment lease with equal monthly lease payments. In this instance, the monthly lease payment probably would be the best evidence of the

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[1138] *See, e.g., In re* Subscription Television of Greater Atlanta, 789 F.2d 1530 (11th Cir. 1986) (supplier of scrambled cable signal entitled to administrative expense claim for 17 days that trustee used and benefitted from signal and not for next 43 days prior to rejection of contract when trustee did not actually use signal); *In re* Bridgeport Plumbing Prods., Inc., 178 B.R. 563 (Bankr. M.D. Ga. 1994) (lessor compensated for administrative expense only for hours debtor actually used equipment, for this measures actual benefit to estate); *In re* Continental Airlines, Inc., 146 B.R. 520 (Bankr. D. Del. 1992) (pre-breach compensation of aircraft lessor based on debtor/lessee's use, not on costs to lessor of bringing aircraft into compliance with return conditions and other costs), *citing* Sharon Steel Corp. v. National Fuel Gas Distrib. Corp., 872 F.2d 36 (3d Cir. 1989) (administrative expense claim for natural gas utilities service agreement set by tariff rate, not contract rate, because tariff rate was amount debtor would have paid if contract had expired); *In re* Peninsula Gunite, 24 B.R. 593 (B.A.P. 9th Cir. 1982) (court may fix different figure than lease based upon actual use by debtor); *In re* Mastercraft Record Plating, Inc., 32 B.R. 106, 114 (Bankr. S.D.N.Y. 1983)(considering reasonable value to estate of use and occupancy; contractual rent not conclusive on value to debtor), *rev'd* ,39 B.R. 654 (S.D.N.Y. 1984); *In re* Palau Corp., 139 B.R. 942, 944 (B.A.P. 9th Cir. 1992), *aff'd*, 18 F.3d 746 (9th Cir.1994) (administrative expenses calculated by direct and substantive benefit to estate). *See also In re* Mr. Gatti's, Inc., 164 B.R. 929, 946 (Bankr. W.D. Tex. 1994) (notwithstanding Section 365(d)(3), real estate lessor not automatically entitled to administrative expense claim for full lease amount); *In re* Orvco, 95 B.R. 724 (B.A.P. 9th Cir. 1989). But *see In re* Pacific-Atlantic Trading Co., 27 F.3d 401 (9th Cir. 1994) (Section 365(d)(3) authorizes administrative status without consideration of Section 503(b)(1)).

> damages of a lessor waiting for the debtor/lessee to elect to breach or perform. Therefore, nonbankruptcy contract principles support using the contract price to determine damages in this context.
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> A whiskey barrel manufacturer contracts prepetition to deliver whiskey barrels to the debtor one year after the bankruptcy filing. Because these barrels must age, the manufacturer must purchase supplies and begin construction a year in advance of delivery—after the filing but before the debtor has elected to perform or breach. If the nondebtor manufacturer's compensation under an interim performance order were determined only by some fraction of the contract price, the manufacturer would be inadequately compensated. However, under contract restitution principles, the manufacturer would be entitled to significant damages for costs incurred while preparing to perform the contract pending a decision to perform or breach.
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> Consider the same whiskey barrel manufacturer if the debtor filed for bankruptcy six months later, so that the interim period during which the estate was not bound to perform or to breach occurred after the initial expenses had been incurred prepetition and the barrels were simply aging in a warehouse. In such a case, the manufacturer did not reasonably and unavoidably sustain any losses as a result of the delay, and under an interim performance order it would receive no compensation. Once again, the principle of compensation for injury governs the analysis to determine the amount entitled to administrative expense priority.

These examples show that appropriate contract principles, such as restitution, focus on the injury to the nondebtor party that performs under the contract pending the debtor's perform/breach decision. Because damages are based on restoring the injured party to the position the party would have enjoyed absent the injury caused by the debtor's delay, determining damages entitled to administrative expense priority under these contract remedies often has no specific connection with the contract price.[1139] Other contract principles, such as the duty to mitigate, would be equally applicable in cases involving interim compensation. Compensation is designed to be remedial and to minimize the adverse consequences of a delay in the decision to breach or perform.

Competing Considerations. Courts continue to try to develop their own remedies to deal with the consequences of delay in contract decisions, perhaps obviating the need for a statutory solution in this area. However, different approaches in the case law and the reports of many practitioners seem to indicate that guidance would be exceedingly helpful, particularly to promote uniform treatment of nondebtor parties by focusing the inquiry on the nondebtor party's injury. In addition to decreasing costs and uncertainty, the Commission's Recommendation to provide specific guidelines would reduce disparate treatment of similarly situated creditors who currently are compensated in different amounts for their temporary performance.

Under this Proposal, courts would assume the difficult task of fashioning interim relief. Interpreting a contract and balancing and protecting the interests of both parties can be a complex undertaking in many cases. Although the contract price might be used presumptively whenever possible, the payment structure or the nature of some contracts may require more challenging determinations of what would constitute fair compensation for interim performance. The problem is not new to bankruptcy courts, which presently conduct some of this analysis in establishing administrative expense priority claims and in other contexts, but the proposed change presents an additional challenge by focusing directly on the costs to the nondebtor party.

Some are concerned that compensation for damages sustained during an interim performance would entail litigation to determine the appropriate amount to be awarded to the nondebtor party. Because contract law inevitably relies on

[1139] Although the official recommendation of the National Bankruptcy Conference is different than the Commission's, the NBC report contains the following discussion that is consistent with the Commission's recommendation. "An order for temporary performance also should be conditioned upon terms which will avoid inequity to the nondebtor. For example, it may be unfair to expect the nondebtor to purchase costly equipment under the contract when the trustee only intends to continue the performance of the contract for a fraction of its full term. If the contract provides for a lump sum payment at the end of the term, an allocation of compensation will have to be made to cover the stated time period on a basis that will equate to a contract rate. These and like problems may require the court to direct the trustee to make additional payments, or reduce the goods or services required to be delivered by the nondebtor or vary the times when they need to be rendered. Such protection of the nondebtor, whatever it may be called, will be analogous to adequate protection under section 361. If no satisfactory arrangement can be devised to properly compensate the nondebtor for being forced into a temporary contract, then the court should not allow it." REFORMING THE BANKRUPTCY CODE: NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 143 (rev. ed. 1997).

litigation to determine the proper damage award, this criticism is unavoidable, regardless of the method of calculation. No measure of damages for interim relief—including the contract price—can avoid litigation. If interim relief is based on the contract price, for example, the parties face potential litigation to determine the appropriate fraction of the contract price to be awarded. There is no contract theory that splits contract prices to guide the courts. For example, a court would have to determine what portion of the contract price a party should receive under an agreement creating a future obligation to perform services or to sell goods. A contract-based remedy, such as restitution, clarifies the factual inquiry for the court and provides a principled basis for the award of damages. Regardless of the prescribed method of determination, awarding appropriate damages to the nondebtor party comes at the cost of a factual inquiry. This is a necessary cost if the nondebtor party is to be fairly compensated.

To the extent that nondebtor parties currently seek and obtain the imposition of time limits to elect to perform/breach/transfer, these parties might obtain less conclusive relief during the pendency of the case. However, the deferral of binding decisions is often in the best interests of all parties, assuming that nondebtor parties are assured of compensation during the interim period.

The adoption of this Proposal might call into question the continuing need for a provision exclusively governing the trustee's obligations to perform under a lease for nonresidential real property pending an election to perform or breach.[1140] The Commission did not specifically consider this question, although the interaction of general proposals with special interest legislation is a continuing theme throughout these proposals. Indeed, as noted earlier in this discussion, the presence of specially applicable legislation combined with improved generic language may create new difficulties both for the special cases and for the general cases.

2.4.4 *Contracts Subject to Section 365; Eliminating the "Executory" Requirement*

Title 11 should be amended to delete all references to "executory" in section 365 and related provisions, and "executoriness" should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.

As the previous discussions have explored, section 365 of the Bankruptcy Code governs the "assumption" (performance), "rejection" (breach), and "assignment" (transfer) of contracts and leases in bankruptcy. Because section 365 currently refers to *executory* contracts and not to all contracts, commencing the

[1140] 11 U.S.C. § 365(d)(3) (1994).

inquiry on the appropriate disposition of a contract depends on whether the parties believe and the court determines that the contract is "executory."[1141]

Development of the Bankruptcy Term "Executory." Under nonbankruptcy law, the term "executory" is a broad modifier, referring to all contracts not fully performed.[1142] Bankruptcy law has developed a different interpretation of the term starting well before the enactment of the Bankruptcy Code of 1978. Section 365 is derived from section 70b of the Bankruptcy Act of 1898, a provision that codified judicially created rules allowing a trustee to reject the debtor's economically burdensome contracts and assume and perform economically beneficial leases or executory contracts.[1143] The Bankruptcy Act offered very little additional guidance for dealing with executory contracts. If courts did not supervise contract dealings, an estate improvidently could become obligated to perform contracts to the detriment of other creditors. For example, a debtor in possession could prefer one unsecured creditor over all others by assuming a debt obligation that then would be entitled to full repayment. To avoid this result, courts developed a more restrictive interpretation of the term "executory" for bankruptcy purposes to ensure contracts would be assumed only if economically beneficial for the estate. However, by many accounts, those approaches were not always consistent.[1144] To ameliorate some of this confusion, Professor Vern Countryman articulated the following "material breach" analysis to identify an "executory" contract that could be assumed or rejected:

> A contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete

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[1141] "The case law confirms that executoriness lies in the eyes of the beholder." *In re* Riodizio, 204 B.R. at 421 (Bankr. S.D.N.Y. 1997). *Compare In re* General Dev. Corp., 84 F.3d 1364, 1374 (11th Cir. 1996)(litigating whether homesite purchase agreement was executory contract, abandoning restrictive definition requiring material performance, noting that "concept of executoriness will no doubt engender additional debate in the future") *with* Phoenix Exploration Inc. v. Yaquinto (*In re* Murexco Petroleum, Inc.), 15 F.3d 60 (5th Cir. 1994) (using strict material breach test, agreement for sale of oil undeveloped reserves was not executory and could not be rejected by trustee).

[1142] *See* 1 S. WILLISTON, CONTRACTS § 14 (3d ed. 1957); GINSBERG & MARTIN ON BANKRUPTCY, Vol. 1 § 7.01[B] 7-5 (Robert E. Ginsberg et al eds. 4th ed. 1997). "The customary meaning of 'executory' in the wider legal world is any contract that isn't fully performed on both sides." Olin McGill & Francis G. Conrad, *Exorcising Executoriness: Functionalist Arguments and Incantations to Avoid Meeting the Devil in the Woods*, 1995-96 NORTON ANN. SURV. BANKR. L. 137, 145 n.51, 163.

[1143] *In re* Austin Dev. Co., 19 F.3d 1077, 1081 (5th Cir.), *cert. denied*, 513 U.S. 874 (1994).

[1144] *See* Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439 (1973).

> performance would constitute a material breach excusing the performance of the other.[1145]

Using the material breach test, courts gauged remaining future performance of both the debtor and the nondebtor to determine whether the estate would benefit by becoming administratively obligated to perform. The 1973 Report of the Commission on the Bankruptcy Laws of the United States indicated that "executory" referred to incompletely performed agreements but did not endorse a succinct statutory definition.[1146] Congress declined to define "executory contract" when it enacted section 365 of the Bankruptcy Code. According to the legislative history, executory contracts were those in which "performance remains due on both sides."[1147]

It seems clear that the requirement of executoriness was developed in large part to prevent unwise or inadvertent assumptions or rejections by trustees, because under the Bankruptcy Act of 1898 there was no requirement of court approval and notice to creditors for those actions. The Bankruptcy Reform Act of 1978 closed that gap by requiring court approval for assumption or rejection, largely eliminating the underlying reason for the constraining concept.[1148] Even using a deferential business judgment standard commonly employed by courts in reviewing motions to assume or reject, a trustee cannot assume a contract if the benefits to the estate clearly were outweighed by the burdens.[1149] The goal to be served by the executoriness test is now met directly by court review.

[1145] *Id.*

[1146] Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-37, Part II, at 198-99 (1973).

[1147] *See* S.Rep. No. 95-989, at 58 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5844.

[1148] 11 U.S.C. § 365(a). *See In re* Superior Toy & Mfg. Co., 78 F.3d 1169, 1172 (7th Cir. 1996) ("Section 365 requires a court to consider whether assumption of the contract in question will further either the rehabilitation or liquidation of the bankruptcy estate"), citing H.R. Rep. No. 595, 95th Cong., 2d Sess. 348-49 (1978), reprinted in 1978 U.S.C.C.A.N. 5963, 6304-05.

[1149] *See e.g.*, Nostas Assocs. v. Costich (*In re* Klein Sleep Prods., Inc.), 78 F.3d 18, 25 (2d Cir. 1996), *cert. denied*, 511 U.S. 1026 (1994) (although court uses business judgment test in deciding whether to approve a trustee's motion to assume, reject, or assign unexpired lease or executory contract, this entails determination that transaction is in best interest of estate); *In re* Orion Pictures Corp., 4 F.3d 1095, 1099 (2d Cir.1993) ("a bankruptcy court . . . should examine a contract and the surrounding circumstances and apply its best 'business judgment' to determine if it would be beneficial or burdensome to the estate to assume it."); Richmond Leasing Co. v. Capital Bank, N.A., 762 F.2d 1303, 1311-12 (5th Cir. 1985) (debtor's decision to assume lease or enter into modification of lease subject to business judgment standard).

A growing case law trend de-emphasizes a strict analysis of the term "executory" in favor of a "functional" analysis, an approach articulated by Professor Jay Westbrook, Michael Andrew, and others.[1150] Using a functional analysis, a court does not consider remaining mutual material performance but instead considers the goals that assumption or rejection were expected to accomplish: enhancement of the estate.[1151] Under this approach, the term "executory" ultimately serves no purpose, for the executory or nonexecutory label is an after-the-fact description designed to fit the court's conclusions about the value of the contract to the estate. Recognizing this fact, a few courts taking the functional approach have declined to make the threshold finding of executoriness at all and simply have focused on whether the estate would be benefitted by performance or breach. Likewise, some courts have taken circuitous analytical routes to avoid lost value that would result from a rigid application of the executory requirement.[1152]

[1150] *See* Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 282 (1989); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991). *In re* General Dev. Corp., 84 F.3d 1364 (11th Cir. 1996) (affirming lower court determination that definition of executoriness has been expanded); *In re* Booth, 19 B.R. 53 (Bankr. D. Utah 1982) (employing functional analysis); *In re* Drexel Burnham Lambert Group, Inc., 138 B.R. 687 (Bankr. S.D.N.Y. 1992); *In re* Leibinger-Roberts, Inc., 105 B.R. 208, 211 (Bankr. E.D.N.Y. 1989) (interpreting executory in broader fashion, weighing benefits and burdens); *In re* Jolly, 574 F.2d 349, 351 (6th Cir.), *cert. denied sub nom.*, Still v. Chattanooga Mem'l Park, 439 U.S. 929 (1978) ; *In re* Arrow Air, Inc., 60 B.R. 117, 121 (Bankr. S.D. Fla. 1986). *In re* Government Sec. Corp., 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989), *aff'd*, 111 B.R. 1007 (S.D. Fla. 1990); *In re* Taylor, 91 B.R. 302, 311 (Bankr. D.N.J. 1988), *aff'd*, 103 B.R. 511 (D.N.J. 1989), *appeal dismissed*, 913 F.2d 102 (3d Cir. 1990). "[T]he functional approach was actually contemplated by Professor Countryman. Professor Countryman suggested that executory contracts be defined in light of the purpose for which the trustee is given the power to assume or reject: to benefit the estate." *In re* Cardinal Industries, 146 B.R. 720, 728 n. 7 (Bankr. S.D. Ohio 1992). *See also* Phar-Mor, Inc. v. Strouss Bldg. Assoc., 204 B.R. 948 (N.D. Ohio 1997) (material breach test helpful but not controlling). *See also* REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 122 (rev. ed. 1997) (term executory should be eliminated as it "carr[ies] the accumulated baggage of too many erroneous preconceptions"); Olin McGill & Hon. Francis G. Conrad, *Exorcising Executoriness: Functionalist Arguments and Incantations to Avoid Meeting the Devil in the Woods*, 1995-96 NORTON ANN. SURV. BANKR. L. 137, 141 n. 22 ("The functional approach makes bankruptcy issues simpler by taking the focus away from executoriness.").

[1151] *In re* Government Sec. Corp., 101 B.R. 343, 349 (Bankr. S.D. Fla. 1989), *aff'd*, 111 B.R. 1007 (S.D. Fla.1990), *citing In re* Jolly, 574 F.2d 349, 351 (6th Cir.), *cert. denied sub nom.*, Still v. Chattanooga Mem'l Park, 439 U.S. 929 (1978); *In re* Taylor, 91 B.R. 302, 311 (Bankr. D.N.J. 1988), *aff'd*, 103 B.R. 511 (D.N.J. 1989), *appeal dismissed*, 913 F.2d 102 (3d Cir.1990); *In re* Bluman, 125 B.R. 359 (Bankr. E.D.N.Y. 1991), *citing In re* Monument Record Corp., 61 B.R. 866, 868 (Bankr. M.D. Tenn.1986) (citations omitted).

[1152] *See In re* Riodizio, 204 B.R. 417 (Bankr. S.D.N.Y. 1997) (citing cases).

The term "executory" is not merely harmless surplusage. First, even though courts decide that a functional analysis of contracts is analytically superior and yields results more consistent with bankruptcy policy objectives, such analysis would appear to depart from the statutory guidelines. To use an arguably more efficient approach, a statutory amendment is advisable to assure that shift and to cause all courts to follow the same route. Second, few would dispute the persistent inconsistencies and difficulties in identifying an executory contract for bankruptcy purposes, a condition that is exacerbated as courts use different tests to identify an executory contract. Finally, the traditional strict interpretation of the executory requirement leads some courts to results that contravene the initial purpose of the restriction because it does not isolate valuable contracts and does not preclude improvident elections to perform or breach.[1153] Some very valuable contracts may be unassumable on account of a strict executory test.[1154] An executoriness analysis therefore can hamper the process of permitting the bankruptcy estate to elect to perform contracts that will be highly beneficial.

So long as the term "executory" remains in the statute, this issue will continue to incite debate and to increase litigation costs without an evident corresponding advantage.[1155] Therefore, the Commission recommends the elimination of all references to the term "executory." This change would not alter the other substantive parameters of section 365 such as the statutory exclusion of loan and financial

[1153] *In re* Norquist, 43 B.R. 224, 226 (Bankr. E.D. Wash. 1984) (strict executory definition precludes rejection of burdensome contracts, defeating one of purposes of definition). *See generally* Jay Westbrook, 74 MINN. L. REV. 227, 282 (1989).

[1154] *See In re* Riodizio, 204 B.R. 417, 423 (Bankr. S.D.N.Y. 1997) (warrant is executory), citing *In re* America W. Airlines, Inc., 179 B.R. 893, 896 (Bankr. D. Ariz. 1995) (stock option not executory); Brown v. Snellen, 96 B.R. 229, 232 (Bankr. W.D. Mo. 1989) (option contract could not be rejected). Compare Gill v. Easebe Enters., 900 F.2d 1417 (9th Cir. 1990) (option contract is executory); *In re* Robert L. Helms Const. & Dev. Co., 110 F.3d 1470 (9th Cir. 1997) (some option contracts are executory, but some are not), *reh'g en banc granted*, 1997 WL 522816 (9th Cir. Aug 20, 1997).

[1155] *See, e.g.*, REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 122 (rev. ed. 1997); Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227, 282 (1989); Morris Shanker, *A Proposed New Executory Contract Statute*, 1993 ANN. SURV. BANKR. L., 129 (term "executory" should be rejected); Morris Shanker, *Bankruptcy Asset Theory and Its Application to Executory Contracts*, 1992 ANN. SURV. BANKR. L. 97. *See also* Michael T. Andrew, *Executory Contracts in Bankruptcy, Understanding "Rejection,"* 59 U. COLO. L. REV. 845 (1988) (term executory is useless in some contexts, although it is important to prevent debtors from assuming contracts in economically inadvisable circumstances); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. COLO. L. REV. 1 (1991).

accommodation contracts.[1156] Rather, the Proposal would streamline the analysis of the debtor's contracts and provide a directive to courts to analyze the relevant considerations guiding one's decision to perform, breach, or transfer a contract, just as a contracting party would do outside of bankruptcy. By putting all contracts on the same track for analysis rather than creating distinctive groups of creditors with uncertain rights (*e.g.*, the limbo state of the undefined class of contracts found to be nonexecutory),[1157] the Proposal would promote the goal of equality of treatment among creditors.[1158] Moreover, this Proposal bypasses the nonuniformity created by the threshold question of executoriness and thus is fairer to all parties.

Competing Considerations. Notwithstanding recent case law developments that de-emphasize the executory requirement, some might be concerned that eliminating any term already in use, including "executory," could have an unsettling effect on case law and thereby encourage new litigation. However, this Proposal would not introduce a foreign concept, but rather would streamline the analysis so that courts can focus on the critical issue of the benefit to the estate, which originally was the intended goal of the executoriness requirement.[1159]

No proposal in this area of the law can eliminate all litigation because court approval is a crucial component and the review of the perform-or-breach-election is an assessment based on the facts and circumstances of each case and each contract. The removal of the threshold executory requirement would permit courts to focus on pertinent case- and estate-related factors and would curtail litigation on tangential

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[1156] *See* 11 U.S.C. § 365(c)(2) (1994) (trustee cannot assume or assign contract to make loan or extent debt financing or financial accommodations). Likewise, other exceptions to the trustee's power to elect are contracts under which applicable law excuses the nondebtor party from accepting performance from or rendering performance to any person or entity other than the debtor (personal service contracts), and leases of nonresidential real property terminated before the order for relief. *See generally* 11 U.S.C. § 365 (1994).

[1157] Jay Lawrence Westbrook, *A Functional Analysis of Executory Contracts*, 74 MINN. L. REV. 227 (1989). *See* Phoenix Exploration Inc. v. Yaquinto (*In re* Murexco Petroleum, Inc.), 15 F.3d 60 (5th Cir. 1994) (trustee not permitted to reject agreement that was nonexecutory because failure for one party to perform would not give rise to material breach).

[1158] "In cases where the nonbankrupt party has fully performed, it makes no sense to talk about assumption or rejection . . . Rejection is meaningless in this context, and assumption would be of no benefit to the estate, serving only to convert the nonbankrupt's claim into a first priority expense of the estate at the expense of the other creditors." *In re* Columbia Gas Sys., Inc, 50 F.3d 233, 239 (3d Cir. 1995), *citing* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 106 (1986).

[1159] *See* Commercial Law League of America, Official Presentation to the National Bankruptcy Review Commission 1 (May 14, 1997) (noting that Proposal would not create substantive change in section 365).

issues relating to the term "executory." By eliminating this source of confusion, costs and unnecessary delays should be minimized.

2.4.5 *Prebankruptcy Waivers of Bankruptcy Code Provisions*

Section 558 of the Bankruptcy Code should provide that except as otherwise provided in title 11, a clause in a contract or lease or a provision in a court order or plan of reorganization executed or issued prior to the commencement of a bankruptcy case does not waive, terminate, restrict, condition, or otherwise modify any rights or defenses provided by title 11. Any issue actually litigated or any issue resolved by consensual agreement between the debtor and a governmental unit in its police or regulatory capacity, whether embodied in a judgment, administrative order or settlement agreement, would be given preclusive effect.

Bankruptcy is a collective statutory remedy for debtors and creditors alike. Unlike a regular civil lawsuit between two parties that freely permits private settlement agreements within reasonable boundaries, bankruptcy law anticipates that the debtor cannot form private agreements circumventing the statutory provisions that protect all parties in the collective action. Similarly, nonbankruptcy commercial law systems generally refuse to recognize debtors'advance waivers of statutory rights or obligations related to enforcement of remedies or debt collection. Parties in secured transactions, for example, cannot execute loan documents that waive certain standards and constraints on collection remedies provided by Article 9 of the Uniform Commercial Code at a time when they cannot fully appreciate the consequences.[1160]

[1160] Section 9-501(3) explicitly precludes waiver of many significant provisions of Article 9, such as those delineating methods of disposition of collateral, borrower's right to redeem collateral, and a secured party's liability for failure to comply with such rules. *See* U.C.C. §§ 9-505, 9-506, 9-507. *See generally* Robin L. Meadows, *Warranties of Title, Foreclosure Sales, and the Proposed Revision of section 9-504: Has the Pendulum Swung too Far*? 65 FORDHAM L. REV. 2419, n.130 (1997) (describing nonwaivability of certain duties and rights of debtor and secured party and nonwaivability of "commercial reasonableness"); Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 342 (1997) (Article 9 does not allow borrower to waive various postdefault remedies in initial loan documents); Fred H. Miller, *Consumers and the Code; The Search for the Proper Formula*, 75 WASH U. L. Q. 187, n.122 (citing nonwaivability of rights and duties, including statute of frauds); Michael M. Greenfield, *The Role of Assent in Article 2 and Article 9*, 75 WASH. U.L.Q. 289, 292 (1997) (Article 9 contains limited recognition of assent problem by prohibiting waivers of certain rights and duties). "The right to a 'commercially reasonable' disposition of collateral under the UCC is so fundamental that in most jurisdictions the debtor may not waive it. . . . In some states, the prohibition on such waivers continues even after the occurrence of a default." John I. Karesh, *Reposession of Collateral and Foreclosure of Security Interests in Leveraged Lease Aircraft Finance Transactions*, 10 AIR & SPACE L., 9, 10 (1995), *citing* Bank of China v. Chan, 937 F.2d 780, 784-86 (2d Cir. 1991) (applying New York law); Bankers Trust Co. v. Dowler & Co., 47 N.Y.2d 128, 134, 417 N.Y.S.2d

In the same way, procedures and remedies provided in state mortgage foreclosure laws generally cannot be waived in advance of a default.[1161]

While it was long assumed that specific rights, effects, or obligations provided by the Bankruptcy Code could not be waived in advance even in the absence of an express nonwaivability Code provision, case law and business practice have begun to call this long-held assumption into question. With increasing regularity, loan documents and workout agreements contain clauses waiving the applicability of the automatic stay if the borrower files for bankruptcy. The agreement may contain a clause providing that "the borrower will not oppose the lender's motion" to obtain relief from the automatic stay or admitting that the collateral is "not necessary to an effective reorganization."[1162]

This issue has not yet produced an overwhelming number of published decisions, but the decisions thus far create significant uncertainty.[1163] Apparently, no

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47, 390 N.E.2d 766 (1979). *See also* United States v. Conrad Publ'g Co., 589 F.2d 949, 952 (8th Cir. 1978) (commercial reasonableness not waivable by debtor).

[1161] GRANT S. NELSON & DALE A. WHITMAN, REAL ESTATE FINANCE LAW § 3.1 (3d ed.1994). "A foundational tenet of mortgage law is that a borrower may not waive the equity of redemption. This rule is intended to protect borrowers from overreaching lenders, and it applies both to personal and commercial transactions." Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301, 342 (1997); Michael H. Schill, *An Economic Analysis of Mortgagor Protection Laws*, 77 VA. L. REV. 489, 533-34 (1991) (certain mortgagor protection laws protect against borrowers' inherent underestimation of risk, but study showed that laws did not yield appreciable difference in cost of borrowing).

[1162] Other typical clauses provide that filing a petition will constitute "bad faith" if intended to forestall foreclosure, or that the debtor agrees to admit the existence of facts that will support a case dismissal order. *See generally* Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1, 26 (1996) (listing sample clauses); Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW., 577 (1997) (same).

[1163] Commentators recently have begun to recount these developments. *See, e.g.* Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 ARIZ. L. REV. 1, 26 (1996); Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW., 577 (1997); Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay In Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. Rev. 1117, 1141 (1996); William J. Burnett, *Prepetition Waivers of the Automatic Stay: Automatic Enforcement Equals Automatic Trouble*, 5 J. BANKR. L. & PRAC. 257 (1996); Marshall E. Tracht, *Contractual Bankruptcy Waivers: Reconciling Theory, Practice, and Law*, 82 CORNELL L. REV. 301 (1997); Rafael Efrat, *The Case for the Limited Enforceability of a Prepetition Waiver of the Automatic Stay*, 32 SAN DIEGO L. REV. 1133 (1995); Bruce H. White, *The Enforceability of Pre-petition Waivers of the Automatic Stay*, 15 AM. BANKR. INST. L. J. 26 (1997); Steven L. Schwarcz, *Freedom to Contract About Bankruptcy*, (Working Draft on File With the National Bankruptcy Review Commission) (suggesting certain classes of transactions would be appropriate court has found a waiver to be self-executing,[1164] and some courts have held that waivers are unenforceable.[1165] Yet, other courts have enforced these provisions on request or have held that these provisions are enforceable in some circumstances.[1166]

Courts advocating the enforceability of such waivers argue that refusing to enforce waivers would deter out-of-court workouts. Looking beyond the overlay of a collective bankruptcy proceeding, they have reasoned that the contractual provision must be upheld in the absence of grounds for rescission. Likewise, courts have reasoned that the debtor is not conclusively entitled to protections such as the automatic stay throughout the entire course of the case, and they have contended that waiving one component of bankruptcy is permissible since the debtor would remain free to use whatever other tools the debtor has not bargained away.[1167]

These clauses are problematic for several reasons, many of which have been identified by courts declining to enforce waiver clauses. First, the statutory rights of creditors should not be altered by prepetition actions of the debtor.[1168] The automatic stay, a frequent subject of prebankruptcy waivers, is one of the most fundamental components of bankruptcy that stops the "inefficient dismembering of the debtor" by individual collection efforts and thus promotes the orderly and efficient administration of the estate for the benefit of all creditors.[1169] If a debtor could limit the scope of the

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subjects of prebankruptcy contracting).

[1164] Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW., 577, 591 (1997) (reporting that there is "no disagreement" that stay waivers are not self-executing); William Bassin, *Why Courts Should Refuse to Enforce Pre-Petition Agreements That Waive Bankruptcy's Automatic Stay Provision*, 28 IND. L. REV. 1, 4 (1994).

[1165] *See, e.g., In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996) (unenforceable per se); Farm Credit of Cen. Fla. v. Polk, 160 B.R. 870 (M.D. Fla. 1993); *In re* Sky Group Int'l, Inc. 108 B.R. 86 (Bankr. W.D. Pa. 1989).

[1166] *See, e.g., In re* Powers, 170 B.R. 480 (Bankr. D. Mass. 1994); *In re* Cheeks, 167 B.R. 817 (Bankr. D.S.C. 1994) *In re* Club Tower, L.P., 138 B.R. 307, 311 (Bankr. N.D. Ga. 1991); *In re* Atrium High Point, 189 B.R. 599 (Bankr. M.D.N.C. 1995); *In re* Citadel Properties, 86 B.R. 275 (Bankr. M.D. Fla. 1988) *In re* Jenkins Court Assoc. L.P., 181 B.R. 33 (Bankr. E.D. Pa. 1995).

[1167] *See, e.g., In re* Atrium High Point, Ltd., 189 B.R. 599, 605 (Bankr. M.D.N.C. 1995).

[1168] *See, e.g.,* William Bassin, *Why Courts Should Refuse to Enforce Pre-Petition Agreements That Waive Bankruptcy's Automatic Stay Provision*, 28 IND. L. REV. 1, 4 (1994), *citing* Maritime Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1204 (3d Cir. 1991) ("stay protects creditors by preventing particular creditors from acting unilaterally in self-interest to obtain payment from a debtor to the detriment of other creditors").

[1169] Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay In Bankruptcy and the Single Asset Loan Workout,* 43 UCLA L. REV. 1117, 1141 (1996) ("Enforcement of these automatic stay, the interests of other creditors could be severely undermined.[1170] With these types of considerations in mind, bankruptcy law and policy generally do not permit parties to make prebankruptcy contracts that affect the postbankruptcy rights of third parties. For example, section 541(c) of the Bankruptcy Code expressly invalidates certain prebankruptcy agreements that preclude property from becoming property of the estate available for distribution to all creditors.[1171] Bankruptcy law also explicitly prohibits parties from making private agreements to avoid the consequences of bankruptcy. In its governance of non-loan executory contracts and leases, section 365 renders unenforceable contract provisions that in any way extend the rights of the nondebtor party in the event of the debtor's bankruptcy.[1172]

The ability of one creditor to negotiate privately with the debtor for special treatment in bankruptcy runs counter to the principle of equitable treatment and could have significant distributional consequences for all other creditors. The creditors on whom this falls hardest are those who are least likely to be at the bargaining table, such as trade creditors, tort victims, environmental claimants, and employees. These kinds of creditors only stand to lose from the enforceability of such clauses. Far from giving contractual claimants enhanced rights in bankruptcy, the Bankruptcy Code generally strives to limit the rights of contractual creditors to promote equality of treatment among creditors. Claims for unmatured interest that may be perfectly valid outside of bankruptcy are unavailable in certain circumstances under section 502; bankruptcy law often overrides negotiated deals outside of bankruptcy that let one creditor collect a high percentage of interest while another collects nothing while the

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devices derogates from the Code's carefully drawn limitations on the ability of private parties to reorder their entitlements in bankruptcy"). Waivers also affect other fundamental policies, i.e. the breathing spell and the opportunity to reorganize. William J. Burnett, *Prepetition Waivers of the Automatic Stay: Automatic Enforcement Equals Automatic Trouble*, 5 J. BANKR. L. & PRAC. 257 (1996).

[1170] Maritime Elec. Co. v. United Jersey Bank, 959 F.2d 1194, 1204 (3d Cir. 1991), *citing* Commerzanstalt v. Telewide Sys., Inc., 790 F.2d 206, 207 (2d Cir. 1986).

[1171] 11 U.S.C. § 541(c)(1) (1994) (rendering inapplicable agreements that restrict or condition transfer of debtor's interest on debtor's insolvency or financial condition).

[1172] *See, e.g.*, 11 U.S.C. § 365(b)(2) (1994) (cure not prerequisite to assumption if default is breach of provision relating to financial condition of debtor, bankruptcy case, or appointment of trustee, or satisfaction of penalty rate on account of nonmonetary default), 11 U.S.C. § 365(e)(1) (1994) (contract or lease cannot be terminated or modified after commencement of bankruptcy case solely because of provision conditioned on insolvency, bankruptcy, or appointment of trustee). "[A]n ipso facto clause is generally of no use in a bankruptcy case. Such clauses alone are not enough to permit the other party to terminate or modify the contract." 1 GINSBERG & MARTIN ON BANKRUPTCY § 7.02[B] 7-12 (Robert E. Ginsberg et al eds. 4th ed. 1997), *citing In re* Joshua Slocum, Ltd., 922 F.2d 1081 (3d Cir. 1990); *In re* Windmill Farms, Inc., 841 F.2d 1467 (9th Cir. 1988).

bankruptcy case is pending. Likewise, Congress also decided to limit secured parties' rights in after-acquired property of a debtor in bankruptcy.[1173]

Beyond the problem of prepetition agreements affecting equality of distribution, it is questionable whether the prepetition debtor has the legal capacity to make decisions about the application of the bankruptcy laws that are binding on the bankruptcy estate. The debtor could not bind the trustee in a Chapter 7 liquidation by waiving in advance the estate's right to an automatic stay. At least one court has taken the view that the prepetition debtor similarly cannot bind the debtor in possession, which is given the rights and duties of the trustee in bankruptcy and is vested with an independent fiduciary obligation to act in the best interest of the bankruptcy estate.[1174] Prepetition debtors frequently are controlled by different parties than postpetition debtors. Management often is replaced in large Chapter 11 cases.[1175] An ailing business can be put in the hands of turnaround management to help resolve economic and operational problems. Some debtors in possession are replaced by Chapter 11 trustees "for cause."[1176] To what extent should these parties, some of whom are vested with fiduciary duties to the estate as well as statutory obligations, be able to disregard their duties on account of a prepetition agreement between two parties? Congress' comprehensive statutory scheme should not be circumvented by a debtor's prepetition agreement with one creditor, or even a few creditors, to waive the applicability of a bankruptcy provision.[1177] Parties should not expect enforcement

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[1173] 11 U.S.C. § 552(a) (1994) (property acquired after filing for bankruptcy not subject to prepetition security agreement, with some exceptions). In addition, Section 5069(c) permits a secured creditor's collateral to be surcharged for reasonable and necessary costs and expenses of preserving or disposing of property to the extent the secured creditor benefitted from those expenditures.

[1174] *See In re* Pease, 195 B.R. 431 (Bankr. D. Neb. 1996) (lack of authority of prepetition debtors renders stay waivers unenforceable per se).

[1175] Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 676 (1993) (empirical study demonstrating high rate of turnover of management in publicly held corporations); *see* Stuart C. Gilson, Bankruptcy, Boards, Banks, and Blockholders, 27 J. FIN. ECON. 355, 370 (1990) (reporting that over half of chief executive officers of 110 NYSE and AMEX firms that were restructured or filed for Chapter 11 bankruptcy left their jobs within two years of event).

[1176] *See* 11 U.S.C. § 1104 (1994) (providing nonexclusive list of factors to warrant appointment or election of trustee).

[1177] Federal Nat'l Bank. v. Koppel, 148 N.E. 379 (Mass. 1925) (refusing to enforce clause in promissory note waiving bankruptcy discharge). "The Bankruptcy Act would in the natural course of business be nullified in the vast majority of debts arising out of contracts, if this were permissible. It would be vain to enact a bankruptcy law with all its elaborate machinery for settlement of the estates of bankrupt debtors, which could so easily be rendered of no effect. The bar of the discharge under the terms of the Bankruptcy Act is not restricted to those instances where the debtor has not of a contract that contravenes the Bankruptcy Code's policies and requirements since bankruptcy is a collective proceeding governed by federal statute.

The bankruptcy system provides clear rules of priority and protection on which all parties can rely to determine the treatment that will be accorded to certain types of creditors.[1178] The statutory priority scheme is part of the burden and benefit of a bankruptcy case and should not be subject to reconstitution by prior agreement or court order entered outside of bankruptcy proceeding. To function properly and fairly, the priority scheme should supplant private agreements or transactions that specifically do not comport with the statutory rules, notwithstanding the good faith of the parties. To further the principles underlying the priority scheme, certain prebankruptcy transactions can be set aside or avoided under sections 544, 546, 547, and 548, often for failure to comply with nonbankruptcy requirements, such as those to perfect security interests under Article 9 of the Uniform Commercial Code.

This discussion should not be construed to mean that bankruptcy law should never recognize the prebankruptcy actions of parties. Indeed, at their core, many bankruptcy law priorities are premised on negotiated bilateral agreements, so long as they follow a conventional path and comply with requirements for notice and other applicable protections. For example, if voluntary creditors wish to obtain preferred treatment in the event of a borrower's bankruptcy, they can take security interests in compliance with the requirements of Article 9 of the Uniform Commercial Code rather than lending on an unsecured basis, as long as they do not do so on the eve of bankruptcy to circumvent the priorities without providing new money or present consideration.[1179] They should not, however, be able to bargain with the prepetition debtor to be treated in a way that violates the Bankruptcy Code's priority scheme.[1180]

Moreover, even if these contract clauses were potentially enforceable, they cannot be distinguished from other contracts that are subject to breach under section 365 of the Bankruptcy Code. As previously discussed, under section 365, the trustee assesses whether to elect to perform or breach the contract and the judge scrutinizes the trustee's decision, based on the best interest of the estate. Although breached contracts are not "avoided," the nondebtor contract party rarely is entitled to specific

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waived his right to plead it." *Id.*, at 380.

[1178] *See, e.g.*, 11 U.S.C. § 507 (1994) (delineating priorities of claims and expenses), § 503 (determining expenses to receive priority as costs of administering estate), § 506 (determining extent to which creditor has secured claim).

[1179] *See* 11 U.S.C. § 547 (1994) (providing rules for avoiding certain prepetition transfers of debtor).

[1180] *But see* 11 U.S.C. § 510(a) (1994) (providing that agreements to subordinate claims are enforceable in bankruptcy to same extent enforceable outside of bankruptcy).

performance, and instead receives damages in a *pro rata* distribution along with creditors of similar priority.[1181]

Even in decisions that uphold waivers of the automatic stay, there is a consistent theme that calls into question the need for such provisions and confuses their application: those courts conclude that the facts of those cases meet the grounds for lifting the stay under section 362(d)(1) or for dismissal under sections 1112 or 305.[1182] Yet, the courts then uphold the prepetition contractual waivers, despite the fact that they contain different bases for lifting the automatic stay from these statutory grounds. Accordingly, the support for contract waivers is dicta in virtually every case. Because the courts refer to both the statutory elements and the contract and thus provide multiple grounds for their decisions, the waivers are not averting litigation, but are compounding the confusion on what is required.

Waiver cases may have a pernicious effect on doctrinal development. For example, some opinions indicate that they uphold the waivers because "dead on arrival" single asset real estate cases are being filed in bad faith. However, these cases are cited for precedential value in other types of cases, including consumer cases dealing with home mortgages.[1183] Bad faith bankruptcy filings should be addressed directly, and if circumstances reveal that these cases have no hope of reorganization, the Code already provides a variety of potential responses that deal with the problem at hand without introducing additional uncertainty, cost, and litigation into the system for future cases.

At the same time, with the prospect of potential enforceability, lenders increasingly include contingencies in loan documents, indentures, and workout, forbearance, and settlement agreements that waive certain rights of the borrower upon

[1181] *See* discussion in Section 2.4.1.

[1182] *See, e.g., In re* Club Tower L.P., 138 B.R. 307 (Bankr. N.D. Ga. 1991); *In re* Citadel Properties, 86 B.R. 275 (Bankr. M.D. Fla. 1988); *see also In re* Powers, 170 B.R. 480, 482 (Bankr. D. Mass.1994) (ordering evidentiary hearing to consider effect of enforcement on other creditors, likelihood of successful reorganization, benefit debtor received from workout agreement as whole, and extent creditor waived rights or would be prejudiced if waiver is not enforced). *See generally* Michael St. Patrick Baxter, *Prepetition Waivers of the Automatic Stay: A Secured Lender's Guide*, 52 BUS. LAW. 577, 585 n. 48, 602 (1997) (noting that courts uphold waivers when no likelihood of reorganization but secured creditor might wish to obtain waiver for other reasons); Daniel B. Bogart, *Games Lawyers Play: Waivers of the Automatic Stay In Bankruptcy and the Single Asset Loan Workout*, 43 UCLA L. Rev. 1117 (1996) (citing support for use of Section 305 to dismiss case involving two party dispute when bankruptcy forum would be no more efficient in handling dispute).

[1183] *See In re* Cheeks, 167 B.R. 817 (Bankr. D.N.C. 1994) (courts enforcing waivers did not limit their holdings to single asset cases).

filing for bankruptcy.[1184] The possible enforceability of prebankruptcy waivers pervasively affects a wide range of private negotiations between lenders and borrowers of every size, from the largest businesses to individual borrowers, both before and after a waiver is incorporated into a loan or workout agreement. Although counsel for both borrower and lender probably know that the enforceability of such waivers is questionable, and counsel typically will not give a legal opinion letter on the enforceability of such waivers, waivers are becoming boilerplate language in loan documentation. The borrower usually is not in a position to insist that the clause be stricken from the agreement.[1185]

The Commission's proposed amendment would clarify that waivers of the automatic stay and similar provisions in prebankruptcy contracts of the debtor are not effective to limit or alter provisions of Title 11. The Recommendation contains generic language because the waivers at issue do not exclusively involve the automatic stay or any other specific provision, and lawyers are sufficiently creative to devise alternative approaches to accomplish the same result. Thus, the statute should address the principle of prohibiting prebankruptcy waivers and not limit this directive to any specific form of waiver. Because waivers also appear in prior plans of reorganization, dismissal orders, and potentially in other court orders, it is important that such prebankruptcy waivers be made ineffective when presented in those forms. A bankruptcy court is free to consider the circumstances surrounding a prior workout attempt in the same way that a court can review the prior business history to appreciate fully the current circumstances and future projections of the debtor.

This Proposal is not intended to alter the preclusive effect of judgments generally. For example, a debtor who has been proven guilty of a substantive allegation that would make a debt nondischargeable, such as civil fraud, could not use this provision to relitigate the facts in a bankruptcy action over nondischargeability. This provision would not require duplicate litigation on substantive matters when issues already have been determined in a nonbankruptcy forum and when those final orders would have preclusive effect. The recommended provision also contains an exception regarding settlements with the government in its police or regulatory capacity, on the assumption that these type of settlements would not involve the waiver of bankruptcy rights and protections that have been the subject of this discussion.

[1184] "'[P]ractically every loan modification or business workout agreement drafted today' contains bankruptcy waiver provisions." *In re* Powers, 170 B.R. 480, 482 (Bankr. D. Mass. 1994), *citing* Jeffrey W. Warren and Wendy V.E. England, *Pre-Petition Waiver of the Automatic Stay is Not Per Se Enforceable,* AM. BANKR. INST. J. 22 (March 1994).

[1185] *See* Memorandum from Harvey R. Miller & Paul M. Basta, Enforceability of Prepetition Waivers of the Automatic Stay (Apr. 7, 1997) (enforcing stay waivers enables creditors with greater economic leverage to obtain these agreements and circumvent Bankruptcy Code provisions intended to benefit all parties in interest).

Competing Considerations. Although the Commission's Recommendation is consistent with the general tenet precluding advance waivers of statutory rights and remedies and with the intention of Congress to restrict the enforcement of contractual rights in bankruptcy,[1186] freedom of contract often is raised as a contrary consideration for this type of proposal. The freedom of contract argument states that it is more efficient for parties to specify their own remedies in advance rather than using remedies provided by statute.[1187] A freedom of contract argument presumes from the outset that all parties were represented at the bargaining table and unanimously agreed to the remedies set forth, relatively unlikely circumstances for most business dealings.[1188] Even if this set of circumstances existed, however, it is highly improbable that parties can accurately predict adequate relief given the myriad unforeseeable consequences that might accompany the debtor's financial collapse at an unknown point in the future. Bankruptcy is designed to provide a structure to deal with unforeseeable events with third party consequences that cannot be replaced by two-party arrangements. Provisions that cannot be waived until the time of default are not unusual in commercial law. Even in two-party agreements, the law recognizes that some rules should not be waivable until events have unfolded and all the parties can appreciate the implications of waiver.

Others argue that enforcing waivers would promote out-of-court workouts.[1189] The Commission supports out-of-court workouts and has sought to make recommendations that will clarify legal questions to facilitate such negotiations, which can be less costly and more efficient. The Commission also has recommended provisions to promote the use of prepackaged plans of reorganization. However, waivers of bankruptcy rights do not necessarily promote efficiency. Because one

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[1186] *See* 124 Cong. Rec. 32,401 (1978) ("The explicit reference in title 11 forbidding the waiver of certain rights is not intended to imply that other rights, such as the right to file a voluntary bankruptcy case under section 301, may be waived").

[1187] *See* Alan Schwartz, *Contracting About Bankruptcy,* 13 J.L. ECON. & ORG. 127 (1997) (favoring privately negotiated solution over government-supplied bankruptcy process); Barry E. Adler, *A Theory of Corporate Insolvency,* 72 N.Y.U. L. REV. 343 (1997); Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992).

[1188] Schwartz, 13 J. L .ECON & ORG., at 114 (noting that contracting about bankruptcy does not take into account involuntary creditors and thus bankruptcy procedures should be required to address their interests, and also noting that his approach assumes equal information for all creditors and no collusion between groups of creditors).

[1189] *See, e.g., In re* Powers, 170 B.R. 480, 483 (Bankr. D. Mass. 1994); *see also* Edward S. Adams & James L. Baillie, *A Privatization Solution to the Legitimacy of Prepetition Waivers of the Automatic Stay*, 38 Ariz. L. Rev. 1, 26 (1996) (case law supports notion that enforcing waivers encourages lenders to attempt workouts outside of bankruptcy).

cannot agree with a creditor to waive the right to file for bankruptcy in advance,[1190] and waivers of specific bankruptcy rights are not self-executing, waivers are not an efficient device to avoid litigation. Even if waivers were not invalid per se, parties still would find themselves in bankruptcy court litigating over the enforceability of particular clauses based on the circumstances of each case.[1191] It may be more expedient to proceed with a lift-stay motion solely on the statutorily-provided grounds rather than having the court do a retrospective analysis of the validity of the waiver. Instead, any "efficiency" created by waivers is due to the leverage they wield for one creditor, not due to the overall promotion of out-of-court workouts.

Limited use of waivers in postdefault situations to promote workouts actually could have an effect opposite to what was intended. There already is evidence that secured creditors have begun to regard a postdefault waiver of bankruptcy as a routine component in lending arrangements and such clauses have been routinely included in so-called boilerplate language in loan agreements. If waivers were enforced routinely, creditors might become more insistent that waivers be signed early in an episode of financial distress. If this becomes standard business practice, workouts would become unattractive alternatives for well-advised debtors, perhaps prompting them to file Chapter 11 immediately, rather than signing these agreements. In that case, the workout alternative would be eliminated in many cases.

2.4.6 *Prepackaged Plans of Reorganization; Section 341 Meeting of Creditors*

Section 341 should provide that upon the motion of any party in interest in a Chapter 11 case that entails a prepackaged plan of reorganization, the court may waive the requirement that the U.S. trustee convene a meeting of creditors.

A method of encouraging workouts that is consistent with the bankruptcy system is the use of prepackaged plans of reorganization. A "prepack" is an efficient approach to Chapter 11 that can be very useful for businesses that need financial reorganization but that do not need operational restructuring or longterm protection of the bankruptcy laws. In an ordinary Chapter 11 case, the debtor files, obtains approval of its disclosure statement, solicits votes, and seeks to have the plan confirmed. The objective of a prepackaged bankruptcy case is to negotiate the terms

[1190] *See, e.g., In re* Weitzen, 3 F. Supp. 698 (S.D.N.Y. 1933), citing Federal Nat'l Bank. v. Koppel, 148 N.E. 379 (Mass. 1925); *In re* Madison, 184 B.R. 686 (Bankr. E.D. Pa. 1995) (agreement not to file bankruptcy for certain time period is not binding).

[1191] *See* William J. Burnett, *Prepetition Waivers of the Automatic Stay: Automatic Enforcement Equals Automatic Trouble*, 5 J. BANKR. L. & PRAC. 257, 283 (1996) (arguing that enforcement of waivers does not necessarily promote efficiency and does not help solve debtor's insolvency problems).

of a financial restructuring in advance of filing and to come into the bankruptcy system ready to confirm a plan. A business works out a plan and solicits votes. Assuming it received the requisite support, the business files for bankruptcy with a potentially confirmable plan in hand and with most of the difficult negotiation already completed. The filing of the petition usually signifies that the majority of the creditors support the proposed plan. The debtor merely needs one or more of the legal mechanisms of title 11 to effectuate the agreement. The debtor that has used a prepack can emerge from bankruptcy within a few months, or even in weeks, and can lower the transaction costs of bankruptcy significantly.

The issue in this Proposal is the applicability of section 341 of the Bankruptcy Code to prepacks. Section 341 requires the U.S. trustee to convene a meeting of creditors in every bankruptcy case.[1192] The Federal Rules of Bankruptcy Procedure establish that in Chapter 7 or Chapter 11 cases, the meeting must be held within twenty to forty days after the court enters an order for relief.[1193] In theory, this meeting provides creditors with a meaningful opportunity to examine the debtor and to obtain important information. However, when parties negotiated and voted on the plan before the debtor even filed a bankruptcy petition, creditors are not likely to receive any significant benefit from the section 341 meeting. Instead, holding the required meeting only delays confirmation significantly without fulfilling its intended function. According to attorneys familiar with the procedure, in some prepacks, the U.S. trustee convenes section 341 meetings only to comply with section 341, while in other prepacks, the U.S. trustee does not hold section 341 meetings, which technically violates section 341.

Holding the section 341 meeting in a prepack case entails an unnecessary and costly time delay because the creditors already have received disclosures from the debtor and support the plan. In a consensual case that otherwise could be confirmed in a day or two, the notice and scheduling requirements for a section 341 meeting can forestall confirmation for at least twenty days. Some parties have reported that the time delay is particularly crucial in a case with transnational implications because of the risk that local authorities in other countries will seize assets of the estate if the case is not resolved on an expedited basis.

[1192] Section 341(a) provides that "[w]ithin a reasonable time after the order for relief in a case under this title, the United States Trustee shall convene and preside at a meeting of creditors." 11 U.S.C. § 341(a) (1994).

[1193] Federal Rule of Bankruptcy Procedure 2002 requires twenty days' notice for section 341 meetings in cases under Chapters 7 or 11 and Federal Rule of Bankruptcy Procedure 2003 provides that the meeting shall be called no less than 20 days and no more than 40 days after the order for relief.

The Commission recommends that section 341 be amended so that the section 341 meeting of creditors is not required in prepacks, as long as the court agrees.[1194] Court discretion would not be cumbersome in this situation, but is important to ensure that the meeting is held if circumstances so require. At the same time, this Proposal would permit any party in interest to request the waiver of the meeting rather than leaving this initial request in the hands of only one party, such as the U.S. trustee. The Proposal is designed to prevent unneeded delays in the Chapter 11 prepack process to minimize cost and to increase efficiency.

The efficacy of the section 341 meeting has been questioned in many contexts outside the context of prepacks. However, this Proposal addresses only the narrow situation of a prepack and does not express an opinion on the use of section 341 meetings in other types of cases.

Competing Considerations. Some might argue that the section 341 meeting serves a structural function and thus should not be subject to waiver, even with court approval. However, because this Proposal preserves court discretion, any benefits of this structural function most likely are outweighed by countervailing benefits.

2.4.7 *Authorization for Local Mediation Programs*

Congress should authorize judicial districts to enact local rules establishing mediation programs in which the court may order non-binding, confidential mediation upon its own motion or upon the motion of any party in interest. The court should be able to order mediation in an adversary proceeding, contested matter, or otherwise in a bankruptcy case, except that the court may not order mediation of a dispute arising in connection with the retention or payment of professionals or in connection with a motion for contempt, sanctions, or other judicial disciplinary matters. The court should have explicit statutory authority to approve the payment of persons performing mediation functions pursuant to the local rules of that district's mediation program who satisfy the training requirements or standards set by the local rules of that district. The statute should provide further that the details of such mediation programs that are not provided herein may be determined by local rule.

Another method of encouraging workouts and reducing unnecessary costs of the bankruptcy process is through the use of mediation, a lower-cost, higher-

[1194] *See* Memorandum from Jay M. Goffman, Proposed Amendments to Bankruptcy Code and Securities Laws Relating to Prepackaged Bankruptcy Cases (June 12, 1997) (recommending that Code be amended to eliminate requirement that U.S. trustee hold section 341 meeting in prepacks, with court approval).

satisfaction alternative to litigation. Not to be confused with arbitration, mediation is a non-binding process using a neutral party to encourage discussion and negotiation that might ultimately narrow or obviate the need for protracted litigation. Mediation offers litigants the opportunity to resolve disputes creatively and provides a catalyst for settlement, while reducing the costs, delay, and burdens that often accompany litigation or the plan negotiation process.[1195] Both Congress and many judicial districts have endorsed cost minimization through case management techniques and alternative dispute resolution. While it may not be directly applicable to bankruptcy courts, Congress enacted the Civil Justice Reform Act of 1990,[1196] which set the groundwork for alternative dispute resolution programs in the district courts.

A considerable number of districts have implemented mediation programs for disputes that arise in bankruptcy cases and adversary proceedings.[1197] The programs are in various stages of development. The Southern District of California, for example, established its mediation program in 1986, while the Northern District of Illinois recently made the necessary local bankruptcy rule changes to implement a voluntary mediation program. However, while the Bankruptcy Rules currently provide for consensual and binding arbitration,[1198] neither the Bankruptcy Code nor Federal Rules of Bankruptcy Procedure authorize the use of mediation programs. Courts have used their "inherent power,"[1199] the Civil Justice Reform Act, or courts' general equitable power under section 105 of the Bankruptcy Code to establish mediation programs that presently are reducing costs and successfully facilitating the

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[1195] *See, e.g.*, JUDGES' DESK BOOK ON COURT ADR, NATIONAL ADR INSTITUTE FOR FEDERAL JUDGES (Center for Public Resources Legal Program 1993); Form of General Order on Mediation, American Bar Association Business Bankruptcy Committee, Chapter 11 Subcommittee Task Force on ADR in Bankruptcy (February 1, 1996).

[1196] 28 U.S.C. § 471 et seq. (setting forth civil justice expense and delay reduction plan). *See generally* A. Leo Levin, *Beyond Techniques of Case Management: The Challenge of the Civil Justice Reform Act of 1990*, 67 ST. JOHN'S L. REV. 877 (1993); Carl Tobias, *Civil Justice Reform Roadmap*, 142 F.R.D. 507 (1992).

[1197] "As of May 9, 1997, twenty-six bankruptcy courts were using mediation (as well as, in some cases, other ADR methods) pursuant to district court or bankruptcy court rules, general orders or guidelines . . . In addition, approximately twenty more bankruptcy courts are considering an ADR program and several others frequently use ADR on an ad hoc basis." Memorandum from Richard S. Toder & Scott D. Talmadge to Professor Elizabeth Warren, Reporter, regarding use of ADR procedures in bankruptcy cases (June 5, 1997).

[1198] FED. R. BANKR. P. 9019(c) (1994) ("On stipulation of the parties to any controversy affecting the estate the court may authorize the matter to be submitted to final and binding arbitration").

[1199] *See, e.g.*, Link v. Wabash R.R. Co., 370 U.S. 626 (1962) (courts have inherent power to manage judicial affairs to achieve orderly and expeditious resolution of cases).

resolution of disputes.[1200] The programs have been successful in resolving numerous issues and disputes involving claims, adversary proceedings, and plan issues. While mediation attempts will not eliminate litigation in all cases, mediation can help to narrow the issues in dispute. This process can be effective for discrete matters that may arise during the course of a bankruptcy case. The plan negotiation process for large and complex cases also can benefit from mediation, which provides a means for bringing many parties to the bargaining table.[1201] Mediation should be available in small cases as well for the same types of reasons.

The Commission recommends that the Judicial Code and the Federal Rules of Bankruptcy Procedure authorize mediation in bankruptcy cases, contested matters, and adversary proceedings. This recommendation should enhance the goals of maximizing payments to creditors and the reorganization effort by minimizing the costs of bankruptcy administration that often are increased by protracted litigation. The Proposal would authorize judges to order parties to attempt mediation. Otherwise, one party in a dispute could withhold consent as a litigation tactic, leverage tool, or for purposes of delay. Because mediation is not binding and entails only a good faith effort by the parties, ordering parties to meet with a mediator should not unduly prejudice any litigant. Some existing mediation programs direct mandatory non-binding mediation with few problems.

While the nationwide authorization of mediation would provide a uniform structural basis, the Commission suggests that most details be left to local rules. With the basic framework in place, districts can determine what type of program best serves their needs, which may depend in part on the types of cases or disputes that dominate their dockets and that experience suggests are well suited for mediation. Although all districts should set standards on the qualifications for mediators, the types of cases in various districts might dictate what those standards should be. The mediator selection process in particular cases also can be determined locally.

[1200] *See* Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 436 - 437 (1995) (explaining how courts use alternative dispute resolution in conjunction with section 105 to manage bankruptcy cases and noting the increasing frequency of the use of mediation).

[1201] *See* FINAL REPORT OF CYRUS R. VANCE, AS MEDIATOR, PURSUANT TO THE STANDING MEDIATION ORDER AND THE MEDIATION ORDER ENTERED IN THE MACY'S REORGANIZATION CASES (Dec. 8, 1994) (reporting attainment of consensual plan, fair treatment of creditors and employees, and significant cost reduction) attached as appendix to paper of Myer O. Sigal, Plan Mediation Proposal for Large Chapter 11 Cases, submitted in connection with testimony to National Bankruptcy Review Commission (May 14, 1997); *see also In re* Eagle-Picher Indust. Inc., 203 B.R. 256, 261 (S.D. Ohio 1996) (in confirmation opinion, describing successful mediation efforts with Injury Claimants Committee and Future Claims Representative in reaching principal elements of plan).

One detail that federal law should address is the authorization of courts to approve payment of a mediator from assets of the bankruptcy estate. Some programs already provide for the payment of mediators, but statutory authority is the proper way to authorize payment. The Commission does not intend to discourage the use of *pro bono* mediation. Currently, the local rules of certain paid mediation programs require mediators to do some *pro bono* mediation, suggesting that both paid and unpaid mediation services may be integrated successfully, and both are important parts of a functional mediation program.

It is unnecessary to delineate the types of matters suitable for mediation. Bankruptcy courts are best able to make this determination in the cases before them, and districts could restrict the range of subject matter in their mediation programs if they thought it appropriate. However, the Commission believes that two types of disputes should not be subject to mediation: issues surrounding the retention or payment of professionals[1202] and matters involving contempt of court, sanctions, or other judicial disciplinary actions. These types of disputes involve issues that belong before the court exclusively for judicial resolution.

Competing Considerations. Because many districts already have established mediation programs, some people question whether specific statutory authority is necessary. In addition, some people may have reservations about authorizing courts to mandate mediation if the parties do not consent. One could argue that strategic requests for mediation could be employed as a delay tactic that would drive up costs, counter to the intent of the mediation programs. Clearly, courts should not order mediation in instances when mediation would be a fruitless and time-draining undertaking.

2.4.8 *Court Review of Appointments to Creditors' Committees*

Subsection (a)(2) of 11 U.S.C. §1102, "Creditors' and equity security holders' committees," should be amended to read as follows:

> **(2) On request of a party in interest and after notice and a hearing, the court may order a change in membership of a committee appointed under subsection (a) of this section if necessary to ensure adequate representation of creditors or of equity security holders. On request of a party in interest, the court may order the appointment of additional committees of**

[1202] Not everyone agrees that professional issues should be excluded *per se*. For example, the ABA's Form of General Order on Mediation Comment 3.0 refers to mediation of disputes relating to employment and compensation of professionals, trustees and examiners "if the mediation simply seeks to resolve factual disputes." However, the Form also notes that a mediated settlement could not affect the court's role under Sections 326-330 of the Bankruptcy Code.

> **creditors or of equity security holders if necessary to assure adequate representation of creditors or of equity security holders. The United States Trustee shall appoint any such committee.**

Committees of unsecured creditors represent and protect the economic interests of unsecured creditors in the Chapter 11 reorganization process.[1203] In large cases, the creditors' committee is likely to be the primary vehicle for unsecured creditors to voice their concerns effectively and to negotiate with the debtor and other creditors.[1204] The committee is intended to provide "dynamic tension" to stimulate productive reorganization efforts through negotiation and oversight.[1205] A creditors' committee wields significant influence in the negotiation of a Chapter 11 case and is a key player in the plan negotiation process.[1206] Therefore, the composition of a creditors' committee is a significant component of a Chapter 11 case. The Bankruptcy Code guides, but does not mandate, the membership of a committee by stating that the committee "shall ordinarily consist" of the holders of the seven largest claims of the kind represented by the committee.

A problem arises when unsecured creditors believe that they are not adequately represented by the unsecured creditors' committee. Creditors serving as committee members owe a fiduciary duty to the unsecured creditors at large whom they represent.[1207] Yet, it is rare for a committee to be challenged for failing to satisfy its duty and to exercise its statutory powers.[1208] To provide adequate representation

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[1203] Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 997-1066 (1993).

[1204] *See* H.R. Rep. No. 95-595, 235, 401 (1978) (creditors' committees will be the "primary negotiating bodies for the formulation of a plan of reorganization," will represent the class of creditors from which they are selected, will provide "supervision of the debtor in possession and of the trustee, and will protect their constituents' interests."). *See also* Advisory Comm. of Major Funding Corp. v. Sommers, 109 F.3d 219, 224 (5th Cir.1997), *quoting In re* AKF Foods, Inc., 36 B.R. 288, 289 (Bankr. E.D.N.Y. 1984) ("function of the creditors' committee is to act as a watchdog on behalf of the larger body of creditors which it represents.").

[1205] Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 449 (1995).

[1206] Virginia Bell & Paul B. Jones, *Creditors' Committees and their Roles in Chapter 11 Reorganizations*, 1993 DET. C.L. REV. 1551, 1576 (1993). *See generally* 11 U.S.C. § 1103 (1994) (delineating powers and duties).

[1207] *In re* ABC Automotive Prods. Corp., 210 B.R. 437, 441 (Bankr. E.D. Pa. 1997), *citing* Woods v. City Nat'l Bank & Trust of Chicago, 312 U.S. 262 (1941).

[1208] *See* Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers and Duties*, 73 MARQ. L.

of the interests of different unsecured creditors, a bankruptcy case might need to have more than one committee of unsecured creditors.[1209] However, because expenses of a creditors' committee are borne by the bankruptcy estate, additional committees are the exception and not the rule.[1210] For example, cases with mass tort liabilities might have a tort claimants' committee and another unsecured creditors' committee representing trade and other conventional unsecured creditors.[1211] A solvent debtor with a large number of equity holders might need an equity committee, while a case with a highly complex debt structure might warrant additional creditors' committees to represent different priority creditor interests. Absent these circumstances, the Chapter 11 system contemplates that one committee accommodate the differences between the members of unsecured creditors community and the size of their debts.[1212]

However appropriate committee appointments might appear at the inception of a case, the committee composition may turn out to be inappropriate. Unsecured creditors may sell their claims to outsiders or to other creditors. Some contingent claims may disappear as debtors agree to perform contracts under section 365. New conflicts among creditors emerge as old conflicts disappear. If creditors can show that the committee inadequately represents creditor interests, the most narrowly tailored solution would be to order the adjustment of that committee rather than the appointment of a separate committee. Currently, the law does not clearly provide for such relief.

REV. 581, 615 (1990).

[1209] 11 U.S.C. § 1102(a)(2) (1994) (court can order appointment of additional committees if necessary to assure adequate representation).

[1210] Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 AM. BANKR. L.J. 431, 451 (1995). *See also In re* Sharon Steel Corp., 100 B.R. 767, 778 (Bankr. W.D. Pa. 1989) (appointment of additional committees is extraordinary remedy that complicates reorganization process and increases costs).

[1211] *See, e.g., In re* Eagle Picher Indus. Inc., 203 B.R. 256, 260 (S.D. Ohio 1996) (in plan confirmation opinion, describing two committees); *In re* Dow Corning Corp., 1997 WL 435029, 95-20512 (Bankr. E.D. Mich. July 29, 1997) (official committee of tort claimants and official committee of unsecured creditors), *rev'd on other grounds*, 96 CV 71456-DT, 1997 WL 469740 (E.D. Mich. June 25, 1997).

[1212] *See* KAREN GROSS, FAILURE AND FORGIVENESS: REBALANCING THE BANKRUPTCY SYSTEM 158-60 (1997) (describing diversity among unsecured creditors in their composition and amount of debt owed); *see also* Memorandum from International Council of Shopping Centers to National Bankruptcy Review Commission, Memorandum in Support of Chapter 11 Working Group #4: Court Review of Appointments to Creditors' Committees (Jan. 17, 1997) (describing particular problems of landlords on creditors' committees).

History of Committee Appointments. Under the Bankruptcy Act of 1898, creditors selected the members of their representative committees.[1213] When Congress altered the business reorganization process in the Bankruptcy Code of 1978, courts became responsible for appointing committees of unsecured creditors in Chapter 11 cases. If parties raised objections to the composition of the creditors' committee, courts could revisit their own appointment decisions and could change the size or membership of committees.[1214]

The U. S. trustee system was established nationwide in all federal judicial districts except those in Alabama and North Carolina under the 1986 amendments to the Bankruptcy Code.[1215] The U.S. trustee system assumed responsibility for the administrative functions, including various case appointments, to reduce the appearance of impropriety that sometimes resulted when judges made appointments.[1216] Congress transferred the "administrative task" of appointing committee members from the courts to the U.S. trustee. When section 1104 of the Code was amended to reflect this change, Congress also repealed the provision that had authorized courts to review their own committee appointments, section 1102(c), and did not replace the section with a reasonably analogous substitute. The resulting statute thus was unclear about whether a court can review the U.S. trustee's committee appointments, and if so, what standard of review is appropriate. Although ten years have elapsed since the passage of the amendments to section 1102, it remains uncertain whether courts can review the U.S. trustee's committee appointment decisions, thereby producing a variety of results.[1217]

[1213] *See, e.g.,* 11 U.S.C. § 609 (repealed 1979); 5 COLLIER ON BANKRUPTCY ¶ 1102.01 (Lawrence P. King et al. eds. 15th ed. 1996).

[1214] "On request of a party in interest and after a notice and a hearing, the court may change the membership or the size of a committee appointed under subsection (a) of this section if the membership of such committee is not representative of the different kinds of claims or interests to be represented." 11 U.S.C. § 1102(c) (repealed 1986).

[1215] Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986, Pub. L. 99-554. The judicial districts in Alabama and North Carolina use a system of bankruptcy administrators that is within the judicial branch in those districts.

[1216] "Congress intended to 'separate the administrative duties from the judicial tasks, leaving bankruptcy judges free to resolve disputes untainted by knowledge of administrative matters unnecessary and perhaps prejudicial to an impartial judicial determination.'" *In re* Barney's, Inc., 197 B.R. 431, 438-39 (Bankr. S.D.N.Y. 1996), *quoting* H.R. REP. NO. 99-764, 18 (1986). *See also* 5 COLLIER ON BANKRUPTCY ¶ 1102.01 (Lawrence P. King et al. eds. 15th ed. 1996); *In re* Texaco Inc., 79 B.R. 560 (Bankr. S.D.N.Y. 1987).

[1217] Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code,* 44 S.C. L. REV. 997, 1035-1037 (collecting cases).

As stated previously, the Bankruptcy Code explicitly authorizes courts to order the appointment of additional committees of unsecured creditors to ensure "adequate representation."[1218] Parties need not pursue the issue with the U.S. trustee before turning to the court.[1219] Reading these provisions literally, only one tool is available for courts to remedy inadequate representation: they can impose an additional financial burden on the estate by requiring the appointment of additional committees rather than taking the more modest step of ordering the alteration of the existing creditors' committee.[1220]

Judicial Interpretation of Availability of Court Review. In considering the question of whether courts can review creditors' committee appointments, some courts have held that section 1102 literally does not authorize this court review.[1221]

[1218] 11 U.S.C. § 1102(a)(2) (1994). Adequate representation is not defined in the Bankruptcy Code and must be determined based on the facts of the case.

[1219] 11 U.S.C. § 1102(a)(1), (a)(2) (1994); 5 COLLIER ON BANKRUPTCY ¶ 1102.02 (Lawrence P. King et al. eds. 15th ed. 1996).

[1220] Courts can review the composition of creditors' committees formed prepetition and then appointed by the U.S. trustee under Section 1102(a)(1). FED. R. BANKR. P. 2007 (1994). The 1991 Advisory Committee Notes state that the rule was not intended "to preclude judicial review under Rule 2020 regarding the appointment of other committees." 8 COLLIER ON BANKRUPTCY ¶ 2007.01 (Lawrence P. King et al. eds. 15th ed. 1996); FED. R. BANKR. P. 2020 (1994) (proceeding to contest act or failure to act by U.S. trustee treated as adversary proceeding under Rule 9014). However, the rules may not create a substantive right that the statute does not provide. 28 U.S.C. § 2075 (1994) (Rules shall not abridge, enlarge, or modify any substantive right).

[1221] *In re* Dow Corning Corp, 96 CV 71456-DT, 1997 WL 469740 (E.D. Mich. June 25, 1997) (U.S. trustee has been given sole authority to appoint members of various committees, and bankruptcy court's *sua sponte* removal of members was outside its authority); *In re* Victory Mkts., Inc., 195 B.R. 9 (N.D.N.Y. 1996) (dismissing appeal for creditor's lack of standing to appeal bankruptcy court determination that Section 1102 forecloses court authority to add creditors to committee); *In re* New Life Fellowship, Inc., 202 B.R. 994, 997 (Bankr. W.D. Okla. 1996) (statute unambiguously deprives court of discretion concerning alteration or abolition of bondholders' committee); *In re* Hills Stores Co., 137 B.R. 4, 8 (Bankr. S.D.N.Y. 1992) (declining to order appointment of subcommittee for subordinated bondholders because Code no longer authorizes the court to add or delete members "except in circumstances not relevant here"); *In re* Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 210 (Bankr. S.D.N.Y. 1990) (denying request of liquidators to be appointed to committee because Code does not authorize judicial appointment and because liquidators failed to show inadequate representation); *In re* McLean Industries, Inc., 70 B.R. 852, 856 n. 2 (Bankr. S.D.N.Y. 1987) (stating in dicta that court no longer has option to change committee membership). *See also In re* Gates Eng'g Co., Inc., 104 B.R. 653, 654 (Bankr. D. Del. 1989) (court holding that it was not empowered to review appointments to committees, but later being interpreted to hold that court could review for abuse of discretion under 11 U.S.C. § 105(a)).

According to this view, creation of an additional committee is the only recourse that the Bankruptcy Code provides to remedy inadequate representation.[1222]

Other courts do not accept this result. They refuse to impose the burden and expense of creating additional committees to remedy inadequate representation when altering the composition of an existing committee would be more suitable.[1223] Other courts have asserted that Congress presumptively intended judicial review of administrative actions absent convincing evidence of a contrary intent.[1224]

In reviewing appointments, these courts apply disparate standards on the merits. Some courts have applied "abuse of discretion" or "arbitrary or capricious" standards[1225] principally based on the authority of section 105(a),[1226] which empowers

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[1222] "Understandably, the courts in Texaco and [Public Service Company of New Hampshire] were concerned with the costs attendant to an additional committee . . . . But section 1102(a) provides that inadequate representation is to be addressed by a court through the creation of another committee. That is what Congress wrote. Its words are not to be ignored. Perhaps it should change the statute, perhaps the cost could [be] ameliorated, or perhaps Congress contemplated relief under other statutes not cited or analyzed by the [petitioning creditors]." *In re* Drexel Burnham Lambert Group, Inc., 118 B.R. 209, 211 (Bankr. S.D.N.Y. 1990); *In re* Victory Mkts., Inc., No. 95-CV- 1619, 1996 WL 365675 (N.D.N.Y. June 21, 1996). *See also In re* Value Merchants, Inc., 202 B.R. 280 (E.D. Wis. 1996) (court could exercise de novo review of membership, but absent arbitrary and capricious appointment, remedy is appointment of additional committees).

[1223] *See, e.g., In re* Public Serv. Co. of N.H., 89 B.R. 1014, 1019 (Bankr. D. N.H. 1988) (declining to appoint additional committee when lesser remedy of expanding existing committee would be adequate and less expensive).

[1224] *In re* Voluntary Purchasing Groups, Inc., 1997 WL 155407, 96-CV396, at *2 (E.D. Tex. March 21, 1997), *citing* Bowen v. Michigan Academy of Family, 476 U.S. 667, 670-671 (1986); *In re* Lykes Bros. Steamship Co., Inc., 200 B.R. 933, 939 (M.D. Fla. 1996).

[1225] The arbitrary and capricious standard used by many courts parallels the Administrative Procedure Act standard, which provides that a reviewing court must defer to an administrative agency's findings of fact unless clearly erroneous. *See* 5 U.S.C. § 701 et seq. However, the application of the Administrative Procedure Act, including its standards of review, to the U.S. trustee program is unclear. *See, e.g., In re* Sharon Steel, 100 B.R. at 786 (even if U.S. trustee activities do fall within A.P.A., standard would be inapplicable to U.S. trustee's informal appointment process); *but see* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1036 (1993) (arguing that formal hearing procedures are not prerequisite to judicial deference to administrative decisions), *citing In re* Vance, 120 B.R. 181 (Bankr. N.D. Okla. 1990).

[1226] Section 105(a) provides that the "court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process." 11 U.S.C. § 105(a) (1994).

courts to issue any order, process, or judgment necessary to effectuate the provisions of title 11.[1227] In essence, courts taking this view require that the movant provide substantial evidence that the U.S. trustee acted arbitrarily and capriciously in its appointment decisions.[1228] This approach fails to provide a tool to deal with decisions that may have been sensible when made, but that are rendered inappropriate by subsequent events.

Rather than spending time reviewing the arbitrariness of the U.S. trustee's decision, other courts simply have reviewed the committee composition to determine directly if the committee is adequately representative.[1229] These courts hold that this approach does not undermine Congressional intent to delegate administrative or ministerial functions to the U.S. trustee, since adequacy of representation is a legal issue and thus inherently falls within the power of the courts.

[1227] *See, e.g., In re* Voluntary Purchasing Groups, Inc., 1997 WL 155407, 96-CV396, at *2 (E.D. Tex. March 21, 1997) (upholding bankruptcy court determination that U.S. trustee abused discretion by appointing "patron" creditors that were not among seven largest creditors and had vastly dissimilar interests to other creditors); *In re* Lykes Bros. S.S. Co., Inc., 200 B.R. 933, 938 (M.D. Fla. 1996) (reversing bankruptcy court and determining that bankruptcy court had authority to review appointments on arbitrary and capricious standard); *In re* Barney's, Inc., 197 B.R. 431, 439 (Bankr. S.D.N.Y. 1996) (U.S. trustee did not arbitrarily and capriciously refuse to remove union employees fund from committee upon debtor's motion); *In re* Columbia Gas Sys., Inc., 133 B.R. 174, 175 (Bankr. D. Del. 1991) (denying committee's motion to adjourn hearing on gas company's motion to be appointed to committee because court is empowered under Section 105(a) to review U.S. trustee's decisions for abuse of discretion); *In re* First RepublicBank Corp., 95 B.R. 58 (Bankr. N.D. Tex. 1988) (U.S. trustee's refusal to remove creditor not arbitrary and capricious).

[1228] *See, e.g. In re* Barney's, 197 B.R. at 439.

[1229] *In re* Sharon Steel Corp., 100 B.R. 767 (Bankr. W.D. Pa. 1989) (vacating U.S. trustee notices that undermined court's order to reconstitute committee); *In re* Public Serv. Co. of N.H., 89 B.R. 1014, 1021 (Bankr. D.N.H. 1988)(ordering U.S. trustee to appoint debenture holders to committee rather than creating separate committee as requested); *In re* Texaco Inc., 79 B.R. 560, 566 (Bankr. S.D.N.Y. 1987) (on motion of debtor, ordering merger of two committees for lack of need of two separate committees). *See also In re* Dow Corning Corp., 194 B.R. 121, 133 (Bankr. E.D. Mich. 1996) (dissolving tort claimant committee *sua sponte*), *stay pending appeal denied*, 194 B.R. 147 (Bankr. E.D. Mich. 1996), *stayed pending appeal*, 96 CV-71456 (E.D. Mich. Apr. 4, 1996), *rev'd*, 96 CV 71456-DT, 1997 WL 469740 (E.D. Mich. June 25, 1997); *In re* Plabell Rubber Prods., 140 B.R. 179 (Bankr. N.D. Ohio 1992) (court empowered under Section 105(a) to review appointments and direct appointment of union to committee). *See also In re* Value Merchants, Inc., 202 B.R. 280 (E.D. Wis. 1996) (bankruptcy court properly exercised de novo review of membership, but could order appointment of additional members only upon finding that U.S. trustee acted arbitrarily and capriciously, which it did). Some courts also have reasoned that the power to order the appointment of a new committee necessarily includes the less drastic remedy of directing the expansion of an existing committee. *In re* Texaco, 79 B.R. at 566; *In re* Public Serv. Co., 89 B.R. at 1020.

The Commission recommends that section 1102(a) of the Bankruptcy Code be amended to authorize courts to review creditors' committee composition and the qualifications of the members for purposes of ensuring that the committees are adequately representative, just as courts were entitled to do prior to the 1986 amendments. This change would ameliorate needless uncertainty on this important creditors' committee issue.[1230] On motion of a party in interest and after notice and a hearing, a court would render an independent decision as to whether the creditors' committee was adequately representative and would order the U.S. trustee to adjust membership if necessary.[1231]

Implicit in this Recommendation is the recognition that the establishment and composition of creditors' committees raise issues that go beyond those administrative responsibilities that fall within the exclusive province of the U.S. trustee. The U.S. trustee is not required to engage in specific procedures for committee appointments and makes no specific findings as to adequate representation, either with respect to the number of committees or the composition of the committees. Rather, the U.S. trustee is required to establish merely that a potential committee member is an unsecured creditor and is willing to serve on the committee.[1232] However, because committee composition invokes a significant question of law, adequate representation, the Commission believes that *de novo* review is appropriate when considering the representative nature of existing committees.[1233] *De novo* review also is the level of scrutiny exercised by courts when they consider the necessity of additional

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[1230] "No issue involving creditors' committees has been the subject of as much concern as the ability to alter the composition of a committee. Unfortunately, no other body of law governing creditors' committees appears to be in such a current state of disarray." Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C.L. REV. 995, 1032 (1993); *see also* Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. REV. 1547, 1596 n. 204, 1597 (1996) (noting that access to court review can be important "safety valve" in committee appointment process).

[1231] *See, e.g., In re* Public Serv. Co., 89 B.R. 1014, 1020 (Bankr. D.N.H. 1988) (ordering U.S. trustee to reconstitute committee).

[1232] 5 COLLIER ON BANKRUPTCY ¶ 1102.01 (Lawrence P. King et al. eds. 15th ed. 1996).

[1233] In the handbook prepared for U.S. trustees in 1993, the Department of Justice acknowledged that "the issue of adequate representation is a question of substantive law and may be determined by the court de novo." U.S. DEPARTMENT OF JUSTICE, U.S. TRUSTEE PROGRAM; CHAPTER 11 POLICY INITIATIVE 97 (Mar. 1993). However, the Department of Justice takes the position that this refers only to courts' power to order additional committees and that existing committee membership is reviewable only under the "arbitrary and capricious" standard. *Id. See also In re* Plabell Rubber Prods., 140 B.R. 179 (Bankr. N.D. Ohio 1992) (U.S. trustee advocating abuse of discretion standard). "Because compliance with section 1102 is a question of both fact and law, a court ordinarily would consider such a matter de novo, relying on its own fact finding and interpretation of the appropriate legal standards." Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C.L. REV. 995, 1034 (1993).

committees,[1234] and therefore courts could consolidate challenges to committee composition and requests for additional committees, which involve similar, if not identical, legal and factual issues.

This Proposal should not be construed as promoting any diminution in the role of the U.S. trustee. Rather, this Recommendation is consistent with the intent of Congress to vest the U.S. trustee with responsibility for ministerial matters associated with creditors' committees while courts retain primary responsibility for resolving legal disputes.

Competing Considerations. Some might prefer the implementation of an arbitrary and capricious standard to review the U.S. trustees' committee appointments. The Commission endorsed the *de novo* standard because of the underlying legal issues, because the U.S. trustee would remain responsible for the actual appointment of committee members, and because plenary review would not be significantly more cumbersome for the courts than the abuse of discretion standard. In addition, using the *de novo* standard closes any gap between a creditor's entitlement for relief through readjustment of the standing committee and the more costly remedy of relief through appointment of a new committee. In addition, a review of the case law and commentary suggests that there is no significant difference between *de novo* review and use of the arbitrary and capricious standard in terms of actual application and use of resources.[1235] In determining whether the U.S. trustee acted arbitrarily and capriciously, the court could hardly avoid reviewing all the facts and circumstances.

Another concern is the potential for delay and increased costs inherent in any opportunity for judicial review. Even a specious motion might result in increased costs and could hinder the progress of a case unless the court addressed such a motion quickly and definitively. An adequately represented creditor arguably could

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[1234] *See, e.g., In re* McLean Indus., Inc., 70 B.R. 852, 857 (Bankr. S.D.N.Y. 1987)("legislative history confirms that bankruptcy judges are to determine de novo, as they had previously, whether an additional committee is necessary to achieve adequate representation"), *citing* H.R. Rep. No. 99-764, at 28 (1986).

[1235] "There have been few reported decisions demonstrating how the 'arbitrary and capricious' standard applies in the bankruptcy context, or how it differs in application from *de novo* review. One example of arbitrary and capricious judgment on the part of the U.S. Trustee might be the failure to remove a committee member who has a clear conflict of interest. [citation omitted] However, such a situation probably would lead to the same result under either standard of review." *See* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code,* 44 S.C. L. REV. 995, 1037 n.164 (1993); *see also In re* Dow Corning, 194 B.R. at 132-33 ("it makes no real sense to say that a court is 'reviewing the U.S. Trustee's action' in appointing a committee under one or the other standard of review when the only issue is adequacy of representation, a question which the statute assigns to the court in the first place"), *rev'd on other grounds,* 96 CV 71456-DT, 1997 WL 469740 (E.D. Mich. June 25, 1997).

use the threat of bringing a motion in court to increase its negotiating leverage. To this end, some commentators have suggested that a debtor should not be able to appeal the composition of a committee selected by the United States trustee because the debtor might have only strategic goals in mind.[1236] For example, a debtor might challenge an adverse decision and request an extension of the exclusivity period on the basis that the debtor does not have a suitably selected creditors' committee with which it can seriously negotiate a plan. The Commission opted not to limit a debtor's ability to raise issues regarding the composition of committees, reasoning that the debtor may have legitimate reasons to seek review of creditors' committee appointments, and courts would be able to recognize instances in which review was sought for illegitimate reasons.[1237]

Others might be concerned about the policy implications of reestablishing court influence over appointments through the proposed review powers. However, the threat of any ethical dilemmas would be constrained by the continuing involvement of the U.S. trustee in the process. Although courts would have the power to review, they would remain removed from the actual appointment process.

2.4.9 *Employee Participation in Bankruptcy Cases*

Changes to the Official Forms, the U.S. Trustee program guidelines and the Federal Rules of Bankruptcy Procedure, are recommended to the Administrative Office of the U.S. Courts, the Executive Office of the U.S. Trustee, and the Advisory Committee on Bankruptcy Rules of the Judicial Conference, as appropriate, in order to improve identification of employment-related obligations and facilitate the participation by employee representatives in bankruptcy cases. The Official Forms for the bankruptcy petition, list of largest creditors, and/or schedules of liabilities should solicit more specific information regarding employee obligations. The U.S. Trustee program guidelines for the formation of creditors' committees should be amended to provide better guidance regarding employee and benefit fund claims. The appointment of employee creditors' committees should be encouraged in appropriate circumstances as a mechanism to resolve claims and other matters affecting the employees in a Chapter 11 case.

[1236] *See* Lawrence K. Snider and John J. Voorhees, Jr., *A Proposal that Recommends Judicial Review of the U.S. Trustee's Appointments to Creditors' Committees Leaves Important Issues, Such as Standing, Unresolved*, NAT'L L. J., B7 (Jan. 27, 1997) (questioning whether debtors should have standing to challenge the composition of committee, since motivation probably would not be in interest of creditors).

[1237] *See* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 1040 n.176 (1993) (collecting cases supporting debtors' right to challenge committee composition).

[Comments by Commissioner Babette Ceccotti]

Given the well-established purpose of Chapter 11 to preserve jobs, participation by employees and their representatives in the reorganization process should be accepted and encouraged. Instead, representatives of employees and retirees and employee benefit funds have faced impediments to active participation in bankruptcy cases despite their recognized status as creditors and parties in interest. These obstacles take many forms, such as a lack of notice of a bankruptcy filing, failure to include debts owed to employees and benefit funds on the debtor's schedules and skepticism by the U.S. Trustee's office in the creditors' committee appointment process regarding claims held by unions or benefit funds. Employees not represented by a labor organization face additional obstacles due to the lack of collective representation. Because reorganizations typically involve significant business decisions affecting employees, the bankruptcy process should more readily accommodate participation by employees and their representatives.

Disclosure of Employment-Related Obligations

Notice and disclosure serve two important functions. First, better disclosure of potential liabilities and issues affecting employees and retirees contributes to a more complete view of the issues likely to arise in the bankruptcy and benefits all parties.[1238] Second, improved notice and more complete disclosure facilitate participation by employee representatives and employee benefit plans. This, in turn, enhances the prospects for a resolution of plan issues on a consensual basis.

One way to improve early and more thorough disclosure of employee-related obligations is amending the Official Bankruptcy Forms. As currently drafted, the Official Forms for the petition and schedules do not sufficiently prompt the preparers to include information about employment-related debts. The petition requires the business debtor to estimate the number of employees, but only for "statistical/administrative" purposes.[1239] Creditors holding unsecured claims entitled to priority and other unsecured claims are listed on Schedules E and F, respectively.[1240] Schedule E contains a list of the priority claims to be disclosed as they appear in Sections 507(a)(2) through (9) (*e.g.*, "wages, salaries and commissions," as described in Section 507(a)(3)), and a category for "other").

[1238] *See* Statement of Michael W. Nicholson, Associate General Counsel, International Union, United Automobile, Aerospace and Agricultural Implement Workers of America (UAW) to the Commission 44-45 (June 20, 1997).

[1239] *See* Form 1, Official Bankruptcy Forms (Voluntary Petition).

[1240] The instructions for the schedules indicate that debts are to be listed only once and that claims that are only partially entitled to a priority should be listed on Schedule E.

However, common wage-related items such as arbitration and other awards for back pay, accrued but unpaid wages, vacation pay or sick leave in excess of the wage priority, severance pay, and claims arising under the Worker Adjustment and Retraining Notification ("WARN") Act are not referenced anywhere on the schedules, thus increasing the likelihood of omission. Nor are monies owed to employee benefit plans, beyond the amounts constituting priority claims under Section 507(a)(4), listed for disclosure. Thus, the debtor's initial court filings may not adequately reflect whether and to what extent employee interests may be affected by the bankruptcy case.

Additional instructions on the forms for disclosure of these obligations would assist the preparers in disclosing these debts.[1241] In turn, the inclusion of this information would aid the U.S. Trustees in their initial investigations early after the filing of the case. Currently, without better information, the U.S. Trustee may have no reason to solicit information about debts owed to employees and employee benefit plans or related matters such as the likelihood of a company's withdrawal from a pension plan, an event which will give rise to a substantial claim.[1242]

Committee Participation

One consequence of incomplete disclosure is that labor organizations and benefit funds are placed at a disadvantage in the committee appointment process. These entities are often omitted from the list of 20 largest creditors used for the appointment of creditors' committees,[1243] even though significant sums may be owed to benefit plans and to employees as of the filing date. Thus, unless the U.S. Trustees' offices seek out this information in connection with their initial investigations, it will be up to the employee representatives themselves—assuming

[1241] For example, a specialized addendum to the Petition and Schedules could require the disclosure of the largest non-insider/non-affiliate employee or retiree claims and claims owed to employee benefit plans. Specific instructions itemizing the various types of potential claims would ensure that preparers recognize these obligations as claims for bankruptcy purposes and disclose them. Monies deducted from payroll wages also should be disclosed. Where the debtor is a party to a collective bargaining agreement, the addendum should so indicate.

[1242] Other events affecting pension plans also give rise to significant liabilities. The Pension Benefit Guaranty Corporation cited the termination of a pension plan as one example where disclosure should be made earlier, rather than later, in the bankruptcy. *See* Letter from William G. Beyer, Deputy General Counsel, PBGC to National Bankruptcy Review Commission (April 11, 1997).

[1243] Rule 1007(d) of the Federal Rules of Bankruptcy Procedure requires a debtor in a voluntary Chapter 11 case to file with the petition a list of the creditors holding the 20 largest unsecured claims. The 1983 Advisory Committee's Note to Rule 1007(d) describes the list as an aid in identifying "the different types of claims existing in the case" for use in the appointment of a creditor's committee.

timely notice of events—to make these obligations known and gain access to the process.[1244] Valuable time may be consumed early in the case with efforts to convince the U.S. Trustee that employment-related debts are in fact *bona fide* claims warranting employee representation.

The creditors' committee is the principal mechanism for collective participation in a Chapter 11 case. The courts have accepted the notion that labor unions and employee benefit plans are "creditors" eligible for membership, and that the inclusion of employee interests is entirely consistent with—if not required by—the diversity requirement of section 1102.[1245] The arguments typically raised in opposition to such participation have been repeatedly rejected: that unions and benefit funds are ineligible for participation because their claims are priority claims; that the union or the benefit fund may object to some element of the reorganization and should therefore be excluded, or that confidential information about the business cannot be shared with these parties.[1246] Nevertheless, employee representatives continue to face the same obstacles to committee participation.[1247]

Changes in the materials promulgated by the U.S. Trustee program would improve the guidance available to U.S. Trustees about employee-related claims and reduce unnecessary disputes over participation. The Office of the U.S. Trustee Program Chapter 11 Policy Initiative (March 1993) regarding the appointment of committees contains no information about the kinds of claims held by employees,

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[1244] The U.S. Trustee program guidelines currently direct the U.S. Trustee to provide notice of the organizational meeting to the largest creditors "based upon the list of the 20 largest creditors provided by the debtor or other available sources." OFFICE OF THE U.S. TRUSTEE PROGRAM CHAPTER 11 POLICY INITIATIVE 62 (Mar. 1993). Providing notice as a matter of course to a labor organization representing the debtor's employees and to any benefit fund not sponsored by the debtor, such as a multi-employer plan to which the debtor makes monthly contributions, might also be considered.

[1245] *See, e.g., In re* Altair Airlines, Inc., 727 F.2d 88 (3d Cir. 1984); *In re* Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996); *In re* Northeast Dairy Cooperative Fed'n, Inc., 59 B.R. 531 (Bankr. N.D.N.Y. 1986); *In re* Enduro Stainless, Inc., 59 B.R. 603 (Bankr. N.D. Ohio 1986); *In re* Salant Corp., 53 B.R. 158 (Bankr. S.D.N.Y. 1985); *In re* Schatz Fed. Bearings Co., 5 B.R. 543 (Bankr. S.D.N.Y. 1980).

[1246] *See, e.g., In re* Barney's, Inc., 197 B.R. 431, 442 (Bankr. S.D.N.Y. 1996) (allegations of potential conflicts over reorganization goals); *In re* Plabell Rubber Prods., 140 B.R. 179, 182 (Bankr. N.D. Ohio 1992) (priority claims); *In re* Northeast Dairy Coop. Fed'n, Inc., 59 B.R. 531, 534 (Bankr. N.D.N.Y. 1986) (priority claims and potential differences over reorganization issues); *In re* Enduro Stainless, Inc., 59 B.R. 603, 605 (Bankr. N.D. Ohio 1986) (confidential information and potential conflicts); *In re* Schatz Fed. Bearings Co., 5 B.R. 543, 548 (Bankr. S.D.N.Y. 1980) (potential conflicts over reorganization issues).

[1247] Recent litigation over committee participation includes, *In re* Lykes Bros. Steamship Co., 200 B.R. 933, 938 (M.D. Fla. 1996); *In re* Barney's, Inc., 197 B.R. 431 (Bankr. S.D.N.Y. 1996).

labor unions and employee benefit plans. Dissemination of basic information about the different kinds of employment-related claims, through the U.S. Trustee guidelines, would clarify issues repeatedly raised in the committee formation process and is consistent with the case law that has developed in this area.

The U.S. Trustee Program guidelines correctly note that unions are eligible for appointment as creditors. However, language suggesting an automatic exclusion where the union's claim is entitled to priority treatment pursuant to section 507(a)(3) and (4)[1248] fails to recognize that payment of priority claims may be but one dimension of a labor organization's or benefit fund's interests in a case. Creditors representing employee interests are intensely focused on the preservation of jobs, whether and to what extent wage and benefit modifications will be sought, and other business decisions that impact the employees, in addition to the payment of priority and other claims. Indeed, courts have cited the need for diversity and the distinct interests represented by these entities in granting them committee appointments.[1249] The courts have not allowed the presence of a priority claim to take precedence over the importance of these factors in ruling on appointment disputes.[1250] This is consistent with a recognition that committees are consensus-building vehicles that provide a forum to resolve diverse interests in a case.[1251] This important function should eclipse technical disputes over whether the employees representatives' priority claims should disqualify them from committee participation. Facilitating participation fosters an inclusive process and promotes a consensual, rather than an adversarial, resolution of the reorganization.

Other Mechanisms for Participation

Official committees are the established means of collective creditor participation in the reorganization. Where employees are represented by a labor

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[1248] The guidelines state: "if the union's entire claim is entitled to priority treatment pursuant to section 507(a)(3) and (4), then the union should not be appointed to the creditors' committee as its interest is fundamentally different from that of the general unsecured creditors." OFFICE OF U.S. TRUSTEE PROGRAM CHAPTER 11 POLICY INITIATIVE 76-77 (Mar. 1993).

[1249] *See, e.g., In re* Altair Airlines, Inc., 727 F.2d 88, 90-91 (3d Cir. 1984); *In re* Northeast Dairy Coop. Fed'n, Inc., 59 B.R. 531, 534 (Bankr. N.D.N.Y. 1986)

[1250] *See In re* Northeast Dairy Coop. Fed'n, Inc., 59 B.R. 531, 534 (Bankr. N.D.N.Y. 1986). *See also In re* Plabell Rubber Prods., 140 B.R. 179 (Bankr. N.D. Ohio 1992); *In re* Salant Corp., 53 B.R. 158 (Bankr. S.D.N.Y. 1985). *But see In re* Allied Delivery Sys., 49 B.R. 700 (Bankr. N.D. Ohio 1985) (suggesting a contrary result).

[1251] *See, e.g., In re* Sharon Steel Corp., 100 B.R. 767, 777-78 (Bankr. W.D. Pa. 1989) *In re* First RepublicBank Corp., 95 B.R. 58, 61 (Bankr. N.D. Tex. 1988); *see generally*, Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. REV. 1547 (June 1996).

organization, or where there are benefit funds that pay employee health and other benefits, participation on official committees provides a voice for employment-related interests. While employees represented by a labor organization have access to the process through their representatives, there has been little opportunity for non-organized employees to participate. One emerging solution is the formation of a committee consisting of employees who are not represented by labor organizations to negotiate employee claim disputes with the debtor. In the recent *Herman's Sporting Goods* bankruptcy, an Official Employees' Committee was appointed for the purpose of representing non-union employees in respect of WARN and related claims asserted as a result of the termination of operations.[1252] The Bankruptcy Court ultimately approved a settlement of the claims negotiated by the committee on behalf of the non-union employees.[1253] Resolution of these claims through the committee allowed the employees and Herman's to avoid litigation over the claims.

The appointment of multiple creditors' committees is usually not favored.[1254] However, where there are issues common to a significant number of employees, and no other means of collective participation, the appointment of a committee to resolve such issues should not be hampered by the presumption against multiple committees. Indeed, the Bankruptcy Code already offers a model for representation of this kind in Section 1114, which provides for the appointment of a retiree committee where the debtor seeks to negotiate changes in retiree health benefits.[1255] As the *Herman's* experience demonstrates, the formation of an employees' committee to pursue specified issues with the debtor is preferable to costly, inefficient litigation and, therefore, should be encouraged.

Competing Considerations. It may be argued that a union or a benefit fund with only a claim entitled to priority cannot adequately represent other creditors holding only general unsecured claims, and therefore should be ineligible for appointment to a creditors' committee. The assumption is that a creditor with an unsecured claim entitled to priority will view the reorganization and claims recovery in a manner too dissimilar from those unsecured creditors whose claims are not entitled to a payment priority. For example, an unsecured creditor entitled to be among the first paid may more readily accept a liquidation alternative than a general unsecured creditor.

[1252] *See In re* Herman's Sporting Goods, Inc., No. 96-33538, (Bankr. D.N.J., June 27, 1996) (Order Compelling the Appointment of An Official Employees Committee).

[1253] *In re* Herman's Sporting Goods, Inc., No. 96-33538 (Bankr. D.N.J., Oct. 21, 1996) (order approving settlement).

[1254] *See, e.g., In re* Sharon Steel Corp., 100 B.R. 767 (Bankr. W.D. Pa. 1989).

[1255] *See* 11 U.S.C. § 1114(d) (1994).

Concerns of this nature may be largely theoretical, however. As noted above, a labor organization or employee benefit fund evaluates a case in light of a variety of factors, not simply the payment of its pre-petition claims. Certainly, a labor union or benefit fund is unlikely to prefer a liquidation where there are jobs to preserve, even where its claim is wholly entitled to priority. Indeed, the fact that creditors may be motivated by multiple interests in a case is not a phenomenon limited to employee representatives. Creditors who are suppliers may be interested in the prospects for a continued business relationship with the debtor and therefore similarly adverse to a liquidation. Nor are enhanced payment opportunities limited to priority wage creditors. Commercial creditors may have alternative sources of payment or non-bankruptcy priorities.

Moreover, there may be too many uncertainties at the outset of a bankruptcy case to justify an automatic exclusion on the basis of a hypothetical, future payout. In any event, potential conflicts involving any creditor are legally insufficient grounds to disqualify creditors from committee membership.[1256] Indeed, such intercreditor conflicts are common among committee members.[1257] Potential conflicts are dealt with as part of the operating rules of the committee or through other means.[1258] The courts have been comfortable applying these rules to labor unions and funds and have rejected disqualification based upon *potential* conflicts, given the interests represented by these creditors.

The consequences of such a technical disqualification from committee membership, particularly on grounds that are unreliable predictors of a creditor's conduct, also should be given significant weight. The creditor's committee is the primary negotiating body for the formulation of a plan of reorganization and enjoys broad authority under the Bankruptcy Code. Disqualification for no other reason except that suggested by the U.S. Trustee guidelines would eliminate a distinct and significant interest from the only collective participatory vehicle in a Chapter 11 case. As summarized by the U.S. Court of Appeals in *Altair Airlines* "there is no reason

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[1256] The courts have required evidence of actual conflicts or other disqualifying behavior. A creditor may be disqualified from serving on a committee where there is evidence of a breach of fiduciary duty or an impermissible conflict with the class of creditors represented by that member. *See In re* Barney's Inc., 197 B.R. 431, 442 (Bankr. S.D.N.Y. 1996); *In re* Microboard Processing, Inc., 95 B.R. 283, 285 (Bankr. D. Conn. 1989).

[1257] *See, e.g., In re* Sharon Steel Corp., 100 B.R. 767, 777 (Bankr. W.D. Pa. 1989) (citing cases).

[1258] *See, e.g., In re* Plabell Rubber Prods., 140 B.R. 179, 181 (Bankr. N.D. Ohio 1992) (union holding "almost entirely" priority claim appointed to committee, with court rejecting the argument that the union may have a conflict, noting that "recourse is available should a dispute arise").

why the voice of the collective bargaining representative should be the one claimant voice excluded from the performance of [the committee's] statutory role."[1259]

2.4.10 *Enhancing the Efficacy of Examiners and Limiting the Grounds for Appointment of Examiners in Chapter 11 Cases*

Congress should amend section 327 to provide for the retention of professionals by examiners for cause under the same standards that govern the retention of other professionals.

The Bankruptcy Code provides for the appointment of examiners in certain Chapter 11 cases. Although they are not used in most cases, examiners perform critical investigatory functions when an independent and impartial inquiry is warranted. The fact that the Code explicitly contemplates the appointment of examiners further safeguards the integrity of the Chapter 11 process.

Because the primary role of an examiner is as investigator, examiners need to have the resources and tools at their disposal to carry out their responsibilities fully and competently. However, the Bankruptcy Code does not provide specific authorization for an examiner to retain professionals to assist in the performance of the examiner's duties. Some courts have permitted examiners to retain professionals under the bankruptcy judges' general all-writs power under section 105(a),[1260] but a specific and direct source of authority would be preferable.

The Commission therefore recommends that bankruptcy courts be authorized, but not required, to permit the retention of professionals for examiners when cause exists to do so. The retention would be governed by the same standards that currently govern the retention of all other professionals as would the entitlement of an examiner's professionals to compensation out of the estate. The need for professional assistance will depend on the duties of the examiner and the circumstances of the case. For example, if an accountant is appointed as an examiner solely to review a debtor's books and records, the accountant is unlikely to require the assistance of a professional. However, an examiner may need to retain professionals with specialized expertise upon the discovery of a particularly complex financial matter. In addition, if an examiner is not an attorney, the examiner may need to retain legal counsel upon uncovering a potential fraudulent conveyance or if parties in interest make allegations against the examiner personally.

[1259] *In re* Altair Airlines, Inc., 727 F.2d 88, 90 (3d Cir. 1984).

[1260] *See, e.g., In re* Tighe Mercantile, Inc., 62 B.R. 995, 1000-1002 (Bankr. S.D. Cal. 1986) (court can use Section 105 to authorize examiner's appointment of professionals where no examiner could carry out duties without professional assistance); *In re* Southmark Corp., 113 B.R. 280 (Bankr. N.D. Tex. 1990).

Competing Consideration. A Chapter 11 case already involves many professionals, and some people might urge that the examiner's power to retain professionals not be expanded due to increased expense to the estate. However, once appointed, the examiner serves an important function helping to protect assets of the estate and investigating problems. The examiner should have the proper tools and appropriate professionals to fulfill this responsibility. In addition, the Commission has a corollary Recommendation to eliminate the requirement that examiners be automatically appointed without evidence of purpose in any case with more than $5,000,000 in unsecured debt (discussed in the following pages), lessening the likelihood that professional costs will be incurred unnecessarily.

The Advisory Committee on Bankruptcy Rules of the Judicial Conference should consider a recommendation that Federal Rule of Bankruptcy Procedure 2004(a) be amended to provide that "On motion of any party in interest or of an examiner appointed under Section 1104 of title 11, the court may order the examination of any entity."

The ability to acquire information under Rule 2004 of the Federal Rules of Bankruptcy Procedure, and to use other discovery tools, can be critical to investigating fraud and other misconduct or mismanagement, which are precisely the responsibilities of an examiner. While parties in interest can request a Rule 2004 examination, an examiner might not be a party in interest under section 1109 of the Bankruptcy Code.[1261] No reported decision has been found denying use of Rule 2004 to an examiner,[1262] but there is little justification for leaving any ambiguity on the matter. This discovery tool should be available to all examiners in pursuing their investigatory functions. Thus, the Commission recommends that the Rules Committee of the Judicial Conference amend Rule 2004(a) to specifically include an examiner's right to request an examination.

Congress should eliminate section 1104(c)(2), which requires the court to order appointment of an examiner upon the request of a party in interest if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes or owing to an insider, exceed $5,000,000.

The Bankruptcy Code clearly mandates the appointment of an examiner in certain circumstances: under section 1104(c) of the Bankruptcy Code, the court must order the appointment of an examiner if an independent investigation would serve the

[1261] *See, e.g., In re* Baldwin United Corp., 46 B.R. 314, 316 (Bankr. S.D. Ohio 1985) (stating in dicta that examiner is not a party in interest).

[1262] *See* Memorandum from Lawrence K. Snider to Professor Elizabeth Warren, regarding Chapter 11 Working Group - Role and Duties of the Examiner 9 (June 5, 1997).

interests of parties in the bankruptcy case, especially in a situation that potentially involves fraud, dishonesty, incompetence, or misconduct in the debtor's management of the estate's affairs.[1263] This requirement is inherently sensible, casting the examiner in the role of independent inquirer to ensure the integrity of the bankruptcy system. However, section 1104(c) contains an additional provision: subsection (2) specifically requires the court to order the appointment of an examiner on the request of a party in interest, if the debtor's fixed, liquidated, unsecured debts to non-insiders, other than debts for goods, services, or taxes, exceed $5,000,000. This appointment is mandatory even if there is no suggestion of mismanagement or wrongdoing, and even if an investigation would impede the interests of creditors and other parties.

At best, the current provision duplicates the requirement to order the appointment of an examiner in the interests of the estate and the estate's creditors. Particularly in large Chapter 11 cases, creditors' committees and their professionals provide a check on management and serve routine investigative functions until a particular situation is suspected that justifies the appointment of an independent examiner.

Section 1104(c)(2) is not merely a benign duplication, however. Because it permits parties to seek the appointment of an examiner when there is no need for an examiner, it offers opportunity for mischief by a party in interest. Requests under this provision can be used as leverage and delay tactics by a few creditors seeking to serve their own interests rather than furthering the interests of the estate and the creditor body overall. A creditor who can threaten to demand an examiner without *any* showing of a legitimate purpose can enhance its own treatment in exchange for withdrawing its demand. Rather than helping to protect the estate, it more likely serves as a strategic tool to cause delay and to increase costs that decrease the funds available to distribute to creditors at large.

For these reasons, some courts observing misuse of the mandatory appointment provision have refused to appoint an examiner under this provision, using waiver or laches as a basis when a request is made late in the case.[1264] However, a

[1263] 11 U.S.C. § 1104(c)(1) (1994) (court shall order appointment of examiner to investigate when circumstances require, including allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, irregularity in affairs, or if appointing examiner is in interests of creditors, equity security holders and other interests of estate).

[1264] *See*, e.g. *In re* Bradlees Stores, Inc., 209 B.R. 36 (Bankr. S.D.N.Y. 1997) (creditors waived right to seek appointment of examiner by waiting until conclusion of thirteen month investigation by debtor's professionals); *see also In re* Schepps Food Stores, Inc., 148 B.R. 27, 30 (S.D. Tex. 1992) (party in interest may waive right to seek appointment of examiner); *In re* Shelter Resources Corp., 35 B.R. 304 (Bankr. N.D. Ohio 1983) (refusing to appoint examiner under this provision after court approved settlement of action at issue).

literal reading of section 1104(c)(2) does not leave room for this discretion when the case involves $5,000,000 in fixed, unsecured debt.[1265]

The Commission recommends the deletion of this arbitrarily-triggered provision. This change would eliminate a provision that easily could become a source of delay. The deletion of this provision will avoid the unnecessary costs of litigation over the question and the costs of hiring an examiner in circumstances not needing an independent investigation. The Commission heard only supportive statements regarding this Proposal to eliminate section 1104(c)(2). The consensus appears to be that section 1104(c)(2) is neither helpful nor necessary to preserve the authority of the court to order the appointment of an examiner in instances when the appointment would serve the interests of parties in the case.

Competing Considerations. Absent an automatic provision for the appointment of an examiner, public investors may not be able to afford to make a request for an examiner. In such cases, however, the Securities and Exchange Commission can take action to protect their interests.

2.4.11 *Valuation*

A creditor's secured claim in personal property should be determined by the property's wholesale price.

A creditor's secured claim in real property should be determined by the property's fair market value, minus hypothetical costs of sale.

The need for statutory guidance on the valuation of collateral was a consistent theme throughout the Commission's hearings. Early versions of the Commission's work in the consumer bankruptcy area included a recommendation for a compromise valuation standard that would not entail a fact-intensive inquiry and could be determined readily without requiring extensive litigation. Once it became clear that the Supreme Court would speak directly to the issue of valuation in *Associates Commercial Corp. v. Rash*, the Commission deferred further consideration of the precise standard to be recommended. In June of 1997, the Supreme Court ruled that the relevant statutory provision, as it currently is written, entails a fact-intensive analysis. With the benefit of the Court's interpretation, the Commission decided to revisit the need for a statutory recommendation to lessen the fact intensive nature of the analysis. At the August 1997 meeting, the Commission discussed the *Rash*

[1265] *See In re* Revco D.S., Inc., 898 F.2d 498 (6th Cir. 1990) (because provision is mandatory and automatic, reversing lower court decision denying motion for appointment of examiner under this provision as duplicative of other investigative efforts), *rev'g*, 93 B.R. 119 (Bankr. N.D. Ohio 1988).

decision and concluded that a statutory amendment would be beneficial and directed that materials be prepared accordingly, which culminated in this recommendation.

The Bankruptcy Code currently does not define the appropriate method to determine "value" of collateral. Instead, the process for valuation is left to case-by-case determination. Section 506(a), which governs the determination of the allowed secured claim, states:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

Due to the flexibility inherent in this provision, the amount of the allowed secured claim may differ depending on the type of bankruptcy case, the kind of property, and the proposed disposition of the collateral.[1266] Even in low-dollar-amount cases, therefore, there is no bright-line rule to give the parties quick, inexpensive answers to a valuation question. With the method for determination left completely undefined, courts have applied disparate methods to similar circumstances, yielding results ranging from the highest (*e.g.* retail) to the lowest (*e.g.*, forced sale) possible valuations, with many options in between, including replacement cost, wholesale, and "midpoint" (the average of net resale proceeds and retail, a compromise method derived from Chapter 13 trustees).[1267] In attempting to resolve the confusion, circuit

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[1266] "'Value' does not necessarily contemplate forced sale or liquidation value of collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case." H.R. REP. NO. 95-595, at 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6312.

[1267] *See Stay Litigation After Rash, Our Two Cents*, at 1-2 (1996) http://www.stinson.com/2cents/rash.htm, which provides further delineation of potential valuation standards: "replacement cost (the current cost of a similar item); fair market value (what a willing buyer would pay for a like item sold by a willing seller); liquidation value (the estimated amount that could be realized from a forced sale of the property at a public auction after proper advertising); orderly liquidation value (the amount that could be realized from a forced sale of the property intact with all related equipment not necessarily at an auction); retail value (the price for which an item is sold at retail); wholesale value (the price for which an item is sold at wholesale); and going concern or enterprise value (the value of an enterprise as a going concern, taking into account goodwill)." *See also* Elliot D. Levin, A Proposal for the National Bankruptcy Review Commission:

courts of appeals have tried to provide more definitive answers, but they too have differed over the proper standard for determining the allowed secured claim.[1268] The announced standards have not always been clear, evidenced by the fact that judges reach conflicting interpretations of the relevant court decisions.[1269]

The United States Supreme Court released a much-awaited decision on this issue, *Associates Commercial Corp. v. Rash*.[1270] *Rash* was a Chapter 13 case involving a tractor truck used by the debtor in his freight hauling business. In an *en banc* opinion reversing the initial appellate ruling that retail value determined the allowed secured claim, the United States Court of Appeals for the Fifth Circuit held that the valuation of a secured creditor's interest under section 506(a) "should start with what the creditor could realize if it repossessed and sold the collateral pursuant to its security agreement, taking into account the purpose of the valuation and the proposed distribution or use of the collateral."[1271] The court therefore determined that the bankruptcy court did not err when it valued the truck at wholesale; this price reflected the secured creditor's yield if it had repossessed and sold the truck.

The Supreme Court reversed and remanded the case. Finding that the first sentence of section 506(a) did not determine the standard of valuation, the Supreme Court looked to the second sentence of that provision, which requires a court to consider the proposed disposition or use of the property. In a Chapter 13 cramdown, the debtor retains the collateral. At the same time, the creditor continues to be at risk for diminution of value from extended use. The proper valuation standard if the collateral remained in the hands of the debtor, said the Supreme Court with only one dissenter, was replacement value less certain costs. Although the term "replacement

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The Fair Distribution of Value Created by the Bankruptcy Process Itself (not dated) (listing various methods of valuation utilized: liquidation, fair value, fair market value, going concern value, and cash value (when property is sold)).

[1268] *Cf. In re* Hoskins, 102 F.3d 311 (7th Cir. 1996) (proper valuation was midpoint between wholesale and retail); *In re* Rash, 90 F.3d 1036 (5th Cir. 1996) (en banc) (net foreclosure value), rev'd, 117 S. Ct. 1879 (1997); Taffi v. United States, 96 F.3d 1190 (9th Cir. 1996) (en banc) (fair market value for real property in individual Chapter 11 case), *cert. denied*, 117 S. Ct. 2478 (1997); *In re* Trimble, 50 F.3d 530 (8th Cir. 1995) (retail value of vehicle without deduction for costs of sale). *See also In re* Valenti, 105 F.3d 55 (2nd Cir. 1997), in which the Second Circuit held that it was within the bankruptcy court's discretion to value at midpoint between wholesale and retail, but "no fixed value, whether it be retail, wholesale, or some combination of the two, should be imposed on every bankruptcy court conducting a § 506(a) valuation." *Id.* at 62.

[1269] *See* Associates Commercial Corp. v. Rash, 90 F.3d 1036, 1060, 1062-63 (5th Cir. 1996) (en banc), in which the majority and dissenting decisions reach differing conclusions on the number of circuit courts that have held in favor of retail valuation.

[1270] 117 S. Ct. 1879 (1997).

[1271] 90 F.3d 1036, 1060 (5th Cir. 1996) (en banc), *rev'd*, 117 S. Ct. 1879 (1997).

value" is sometimes equated with retail value, the Supreme Court's definition explicitly requires deductions for certain costs, such as warranties, inventory costs, storage, and reconditioning. The application of this standard would entail a fact-intensive analysis, with the actual method of determination to be left to individual judges.

The Supreme Court's adoption of a replacement-value-less-certain-costs standard reflected a deliberate policy choice. In footnote five, the Court indicates that it aimed to clarify the law, rejecting "a ruleless approach allowing use of different valuation standards based on the facts and circumstances of individual cases."

Notwithstanding the announced intent of this standard to provide a clear rule, the application of the standard announced by the court is fraught with ambiguity. In footnote six, the Supreme Court commented that the fact that the replacement value standard "governs in cramdown cases leaves to bankruptcy courts, as triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of property."[1272] The Supreme Court went on to describe the types of expenses that should be deducted when determining replacement value, each of which requires an independent valuation. Variations based on the types of property and the expenses to be deducted make clear that a fact-intensive analysis and multiple valuations would be inevitable.

As stated previously, the Court uses the term "replacement value," a term sometimes associated with retail value. The explanation the Court gives this definition, however, indicates a different, more complex valuation. The Supreme Court's ruling was based on the interpretation of section 506(a) rather than a more comprehensive policy judgment about the appropriate valuation standard. The Commission recommends that Congress provide more guidance in this area to ensure that similar cases would be treated more equally and to reduce unnecessary litigation and transaction costs. The Commission's Recommendation aims at a valuation based on fewer factors to be determined using a standard provable with relatively more ease.

Significance of Establishing a Standard to Determine the Allowed Secured Claim and the Problems with the "Replacement Value Less Certain Costs" Standard. Although the Supreme Court ruled in the context of a Chapter 13 cramdown, the standard for valuing the allowed secured claim has significant

[1272] *In re* Rash, 117 S. Ct. 1879, 1886 n.6 (1997).

implications in all cases under all chapters of the Bankruptcy Code.[1273] Issues involving the valuation of property arise in almost every business bankruptcy case.[1274] It is not possible to overstate the significance of clarifying the method to determine the allowed secured claim. Valuation is central to adequate protection contests and to the plan confirmation process, and thus greatly affects negotiations in complex business reorganization cases from the day of filing (if not before) to the day of confirmation.[1275] Although section 506(a) establishes that valuation is to be done on a case-by-case basis, the Supreme Court's interpretation of section 506(a) calls into question the valuation standards heretofore used in all of these contexts.[1276]

As a consequence of the approach taken by the Supreme Court majority, commentators fear that the *Rash* decision will exacerbate litigation on valuation. There are numerous practical difficulties of determining replacement value,[1277] particularly under the open-ended approach set forth in footnote six of the decision.[1278] The inquiry prescribed by the Court entails many factual determinations regarding the amounts that must be deducted from the retail price. In many cases, the secured claim will be determined after a protracted "battle of the experts,"[1279]

[1273] *See, e.g., In re* Inter-City Beverage Co., 209 B.R. 931 (Bankr. W.D. Mo. 1997) (applying Supreme Court's *Rash* decision outside context of Chapter 13 cramdown to value property sold in section 363 sale in Chapter 11 bankruptcy).

[1274] "As Justice Stevens aptly points out in his dissent, section 506(a) is a 'utility' provision in that applies throughout the various chapters of the Code. This interpretation of the value of the secured claim also will apply to Chapter 7, 11 and 12." Robert F. Mitch, *The Rash Decision: A Question of Value*, AM. BANKR. INST. J., 18, 19 (July/Aug. 1997).

[1275] *See generally* Chaim J. Fortgang & Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 UCLA L. Rev. 1061 (1985) (comprehensive review of valuation issues).

[1276] The Supreme Court's decision in *Rash* potentially, although not definitively, calls into question all section 506(a) opinions interpreting the appropriate valuation standard. Some of these opinions are cited in this Proposal not for their continuing precedential value, but rather to provide context or for their philosophical bases.

[1277] *See* Hon. Frank H. Easterbrook, Bankruptcy Reform, Luncheon Address to the National Bankruptcy Review Commission Chicago Regional Hearing, at 4 (July 17, 1997) ("Replacement value cannot be looked up. It must be litigated; and in the process the value of the asset will be paid out to the lawyers rather than to the creditors").

[1278] *See* Letter from G. Ray Warner, Valuation - Need to Establish Statutory Guidelines to National Bankruptcy Review Commission 1 (July 30, 1997) (noting that Supreme Court left to each bankruptcy court the proper method of determining value).

[1279] *See* Robert F. Mitch, "*The Rash Decision: A Question of Value in Context*," Am. Bankr. Inst. J., 18, 19 (July/Aug. 1997).

which can dissipate assets that otherwise would be available for distribution to other creditors.

This Proposal recommends that the same baseline standards be employed for all valuation purposes. While the language of section 506(a) has been interpreted to permit—and perhaps to mandate—different standards depending on the context of the valuation, it is not entirely clear why the same piece of property should be valued by various standards in multiple proceedings depending on the nature of each proceeding. Although valuation questions arise in a variety of legal contexts, the factual circumstances warranting valuation are limited to when the debtor plans to retain the property.[1280] There has been little explanation for why one valuation standard should be used for adequate protection and another for plan confirmation, one for determining the value of nonexempt property and another for the redemption of exempt property. Nor has there been an adequate argument made for why valuations in Chapter 11 should be different from those in other chapters.[1281] Without a clearly-articulated principle to justify the propriety of various valuation standards in different procedural contexts, confusion is compounded with no offsetting gain. A clearer standard that does not change from one factual setting to another is warranted to provide certainty and consistency for all valuation determinations.

The variety of applications of valuation standards demonstrate that no particular method can be deemed "pro-debtor" or "pro-creditor." Depending on the circumstances, parties have different stakes in favoring a high or low valuation. For example, some might assume that the full "replacement value" standard is favorable to creditors. However, if the replacement value standard is used in automatic stay hearings, a court is more likely to find that the debtor has equity in the collateral and thus not lift the stay to permit the creditor to proceed with its rights against the property. Likewise, a creditor is less likely to be entitled to adequate protection payments using a high replacement value standard even though the creditor may not be fully protected in the event of a foreclosure if the reorganization effort fails.[1282] High valuation therefore can leave a secured creditor unprotected. Depending on the

[1280] An estimate of value is not needed if the property is being sold. This is particularly true given the Commission's Recommendation to clarify section 363(f) so that the value of the property is not relevant to the decision to sell free and clear.

[1281] *See In re* Hoskins, 102 F.3d 311, 317 (7th Cir. 1996) (Easterbrook, J. concurring) (advocating that valuation rules be identical across chapters).

[1282] *See* Letter from G. Ray Warner , Valuation **-** Need to Establish Statutory Guidelines to National Bankruptcy Review Commission 2 (July 30, 1997). *See generally* United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 371-72 (1988) (interpreting section 506(a) in considering creditors' entitlement to adequate protection and determining that loss of right of immediate foreclosure is not factor to be considered in valuing creditor's interest in collateral).

context, the valuation standard can yield quite different consequences. In addition, no method of valuation is uniformly favorable to all creditors; the method of valuation that benefits a secured creditor in a particular situation is correspondingly less beneficial to unsecured creditors.[1283] All parties have an important stake in the outcome of a valuation dispute.

A relatively simple standard would reduce litigation costs while it increases the predictability of outcomes, thereby encouraging parties to settle their differences without always turning to the courts. A clear standard also would promote consistency in application among different judges and different districts, increasing the likelihood that similar cases will be analyzed using similar legal principles.

One issue that is equally critical to this debate, although somewhat beyond the scope of this particular Proposal, is the proper timing of determining the amount of the allowed secured claim. If the value of the collateral is determined at the beginning of a case, the debtor and the estate capture the benefit of any subsequent appreciation in the property's value. On the other hand, if the secured creditor's claim is not determined until the end of the case, the secured creditor will capture the value of any appreciation even if the appreciation is at least partially attributable to the efforts of the debtor or unsecured creditors. Timing therefore determines which parties benefit from property appreciation and reduction of secured debt principal during the pendency of the case. Some bankruptcy courts value property on a date certain, such as the petition date or the date of confirmation.[1284] However, the Court of Appeals for the Fifth Circuit recently held that a bright-line rule for timing is inappropriate because the Code gives no statutory basis for such a requirement.[1285] A creditor or other party can request valuation, or multiple determinations, at any time during the case. If the creditor becomes oversecured during that period, it will be so treated thereafter. Therefore, creditors face no constraints on the timing of valuation and the opportunity for successive determinations, and the secured creditor always can receive the benefit of appreciation of its collateral, whether or not this is appropriate from a policy perspective. This is true even if the appreciation is more properly attributed to the increasing efficacy of the debtor as a going concern or to particular contributions of unsecured creditors. Although the instant Proposal contains no recommendation on timing, the implications of timing should be kept in

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[1283] "If a bankruptcy court assigns a liquidation value to the collateral of secured creditors, it thereby awards the surplus to the unsecured creditors or to the debtor." David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 2 (1996).

[1284] *See, e.g., In re* Hulen Park Place, Ltd., 130 B.R. 39, 43 (N.D. Tex. 1991) (whether creditor's claim is oversecured must be determined as of petition date); *In re* Landing Assoc., Ltd., 122 B.R. 288, 297 (Bankr. W.D.Tex.1990) (measurement date is confirmation date).

[1285] *In re* T-H New Orleans Partnership, 116 F.3d 790 (5th Cir. 1997).

mind when considering the proposed valuation standards, and Congress may wish to consider standards for timing of valuation.

Wholesale Price as a Compromise Bright-Line Standard. Among the spectrum of various options for valuation, from retail (highest value) to forced sale (lowest value), the Commission recommends that a price in the middle—wholesale price—be used to determine the allowed secured claim for personal property under section 506(a). This approach is supported by policy considerations and offers several advantages.

Many items of personal property have a readily identifiable wholesale price. Wholesale price satisfies the first fundamental requirement for a bright-line rule—that it be workable—and thus helps to reduce transaction costs in bankruptcy.[1286] Although many items have a wholesale market, a wholesale value can be calculated even when an item does not have a readily-identified wholesale market by reference to a retail market for similar goods. Because the term "wholesale" triggers a distinction between old and new goods, it helps identify the proper market. The proper market is one that deals in goods of the kind to be valued in their current state. In a consumer context, such property will nearly always be used, although in a business context, new or used property might be the correct valuation. Inventory, for example, might be valued at "wholesale–new," while the office machinery might be "wholesale–used." No further calculation is needed.

The Supreme Court's opinion in *Rash* implicitly recognized this calculation, prompting the court to require that expenses that would not be reflected in a wholesale value be deducted from the "replacement" value. Following the Supreme Court's instructions in footnote six, a court likely would start with retail and subtract most costs that comprise the difference between the retail and wholesale prices.[1287] By making wholesale valuation the standard, in cases where no wholesale market exists, one readily could construct the price.

Another reason to support a wholesale valuation standard is the importance of developing a "compromise" valuation to reflect the competing interests of debtors

[1286] *See, e.g.*, Hon. Edith H. Jones, Recommendations for Reform of Consumer Bankruptcy Law 18 (Aug. 6, 1997 draft) (recommending adoption of simple standard for valuing collateral).

[1287] *See* Hon. Frank H. Easterbrook, Bankruptcy Reform, Luncheon Address to the National Bankruptcy Review Commission Chicago Regional Hearing, 5 (July 17, 1997). Examples of such costs offered by the Supreme Court included warranties, inventory, storage, reconditioning, and costs associated with modifications to the property that would not be subject to the creditor's lien under state law. *Rash*, 117 S. Ct. at 1886 n.6.

and creditors.[1288] Wholesale price provides a compromise between the lower valuations, such as the foreclosure price, and the higher valuations, such as retail price.[1289] Wholesale price can be viewed as a point on a long spectrum that is not at either end. However, because forced sales often yield so little, wholesale is often much closer to retail than to foreclosure.[1290]

Another compromise that has been suggested is specifically denominated a "midpoint" valuation, a standard embraced by the Seventh Circuit Court of Appeals

[1288] *In re* Hoskins, 102 F.3d 311 (7th Cir. 1996) (adopting midpoint valuation); *In re* Valenti 105 F.3d 55 (2d Cir. 1997) (bankruptcy court did not err by upholding midpoint valuation).

[1289] Forced sale value should not be equated with wholesale value. *Taffi v. United States* , 68 F.3d 306, 308 (9th Cir. 1995), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996) *cert. denied*, 117 S. Ct. 2478. "Such sales are notoriously poor in producing cash proceeds." David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 2 (1996). Forced sale prices tend not to adequately value property, and the failure to obtain the best price for collateral does not, by itself, permit a sale to be set aside as commercially unreasonable. U.C.C. § 9-507(2). *See, e.g.*, Chavers v. Frazier, 93 B.R. 366, 368 (Bankr. M.D. Tenn. 1989) (airplane that was insured for $700,000 sold at Article 9 sale for $415,000). "The overlooked problem, of course is that 'retail' and 'wholesale' blue book prices have never been proxies for 'replacement' and 'forced sale' values. Wholesale value has never represented the amount that a creditor recovers after repossession and resale. Similarly, retail value has little to do with what a consumer would have to pay to buy a replacement automobile of like condition without a warranty from another consumer." Gary Klein, *Opinion Raises More Questions Than it Answers*, AM. BANKR. INST. J. 18 (July/Aug. 1997).

[1290] Armstrong v. Csurilla, 817 P.2d 1221 (N.M. 1991) (discussing low prices that foreclosure sales often bring and when they can be deemed inadequate); Alvin C. Harrell, *UCC Article 9 Drafting Committee Considers October 1996 Draft*, 51 CONS. FIN. L Q. REP. (1997) (reporting that committee met to discuss low price foreclosure sales, among other issues); Donald J. Rapson, *Deficient Treatment of Deficiency Claims: Gilmore Would have Repented*, 75 WASH U.L.Q. 491 (1997) (urging adoption of rule deal with prevalent tendency for secured parties to bid on collateral in foreclosure sales for far less than fair market value and then collect significant deficiency judgment); Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B, and 9 Be Fair to Consumers*?, 75 WASH. U.L.Q. 69, 133,137 (1997) (noting continual problem of sales yielding values at far less than market price, citing studies of low disposition prices in consumer sales), citing David B. McMahon, *Commercially Reasonable Sales and Deficiency Judgments Under UCC Article 9: An Analysis of Revision Proposals*, 48 CONSUMER FIN. L.Q. REP. 64 (1994); "[T]he only bidder at 99% of foreclosure sales is the mortgagee. . . . State foreclosure laws have failed to adequately protect the debtor from low sales prices. The statutory notice requirements generate little interest and most mortgagees have little incentive to advertise." Robert Burford, *Can Mortgage Foreclosure Sales Really be Fraudulent Conveyances Under Section 548(a)(2) of the Bankruptcy Code*?, 22 HOUS. L. REV. 1221, 1248 (1985); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 320-21 n.52 (sales procedures used by bankruptcy courts are "vastly superior to those employed in the state remedies subsystem"). *But see* Rash, 90 F.3d at 1052 n.20 (secured creditor presented testimony that it regularly received 92% of retail price for its trucks at foreclosure sales), *rev'd on other grounds*, 117 S.Ct. 1879 (1997).

in *In re Hoskins* prior to the *Rash* decision.[1291] In *Hoskins*, the bankruptcy court had approved a valuation of the collateral that literally was the average of foreclosure value (but called wholesale in the case) and retail. Because the Chapter 13 trustee did not appeal the court's use of a midpoint value on behalf of the unsecured creditors, the foreclosure value was not an option presented to the Seventh Circuit. The court settled on midpoint valuation, which has the benefit of ensuring that neither the secured creditors nor the unsecured creditors reaps a benefit at the complete expense of the other group. Such a standard avoids windfalls and neutralizes the strategic power that either set of creditors would enjoy under the alternative rules.[1292]

A wholesale valuation accomplishes much of the same goal of compromise because it permits the parties to share in the benefits of the reorganization. A compromise approach is consistent with the notion that the chosen valuation standard should not create perverse incentives to use bankruptcy strategically. If creditors can count on property valuations well in excess of the creditors' state law entitlements, then they have an incentive to force bankruptcy filings rather than out-of-court workouts. At the same time, if property valuations in bankruptcy will be far below what the debtor could yield by selling the property, the debtor can use bankruptcy to extract value from creditors in ways that are not consistent with bankruptcy principles. A clear standard pegged at a compromise point is most likely to keep strategic maneuvering by either party to a minimum.

While "wholesale" and "midpoint" might be similar to each other in many cases, using "wholesale" valuation has clear advantages. Unlike the "midpoint" compromise which requires separate valuation of two points—retail and foreclosure—the wholesale valuation requires the identification of only one price in many cases. Certainty increases as cost decreases with a wholesale valuation.

An important policy consideration underlies adoption of a wholesale valuation. Quite significantly, adoption of a wholesale valuation ensures that a creditor's secured claim will cover at least what the creditor would have received under state law. This standard properly defines property rights in the absence of an overriding bankruptcy policy.[1293] The Uniform Commercial Code entitles a secured

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[1291] *In re* Hoskins, 102 F.3d 311 (7th Cir. 1996) (average of wholesale and retail value).

[1292] *See, e.g.*, Hoskins, 102 F.3d at 317 (people who find themselves in a bilateral monopoly situation will often agree simply to split the difference). *See also In re* Valenti, 105 F.3d 55 (2d Cir. 1997) (upholding midpoint valuation).

[1293] Butner v. United States, 440 U.S. 48 (1979); *In re* Hoskins, 102 F.3d 31, 317 (7th Cir. 1996) (Easterbrook, J. concurring). Associates Commercial Corp. v. Rash, 90 F.3d 1036, 1042, (5th Cir. 1996) (en banc) (if creditor is entitled to replacement cost, would modify extent to which creditor is secured under state law), *rev'd*, 117 S. Ct. 1879 (1997).

creditor to seize and sell the collateral in a commercially reasonable fashion, such as an auction.[1294] If the creditor is entitled to a higher replacement cost or retail, the creditor has a larger entitlement than if the debtor surrendered the property, without having to incur the expenses necessary to fetch a retail price. Using a wholesale valuation protects secured creditors at least for the resale price, which some argue is the most accurate reflection of state law entitlements.[1295] Of course, in any limited-asset system such as bankruptcy, what is guaranteed to the creditor is taken from others. Wholesale valuation, because it is typically higher than foreclosure or repossession valuation, potentially provides secured creditors with a bit more than they would receive under nonbankruptcy law. By looking to wholesale price, a secured creditor should be protected at least for "the equivalent of recourse to the collateral,"[1296] when the creditor gets, in effect, its best price.

The wholesale standard also is fair to debtors. A debtor who retains collateral will have to pay more than liquidation value on the allowed secured claim, but the debtor has the opportunity to keep the property, which the debtor could not do outside bankruptcy. Thus the debtor also receives a benefit it would not have if the property had been repossessed under state law.

No valuation standard will be wholly satisfactory to all parties. The zero-sum game of many bankruptcy decisions necessarily reveals itself somewhere in the process. Using wholesale valuation, unsecured creditors may be the losers as compared to what they could have received if foreclosure value was adopted. The more assets in a business that are shifted to the secured creditors, the fewer assets that will be available for the unsecured creditors. At the same time, wholesale is less likely than the higher retail standard to cut unsecured creditors out completely than the higher retail standard.

[1294] U.C.C. §§ 9-502 - 9-505.

[1295] *Rash*, 90 F.3d at 1042 (en banc), *rev'd*, 117 S.Ct. 1879 (1997); Hoskins, 102 F.3d at 317 (Easterbrook, J. concurring) ("If the debtor must pay the secured creditor the retail value of the collateral in order to retain the collateral under section 1325(a)(5)(B), the apparent congruence of protection afforded by sections 1325(a)(5)(B) and (c) [providing option to surrender collateral] would be lost."); *In re* Maddox, 200 B.R. 546, 553 (D.N.J. 1996) (affirming bankruptcy court's application of wholesale value to vehicles to be retained in Chapter 13).

[1296] S. Andrew Bowman & William M. Thompson, *Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection*, 15 IND. L. REV. 569. 577 (1982), *cited in Rash*, 90 F.3d at 1047, *rev'd* , 117 S. Ct. 1879 (1997). "A debtor may cram down a plan either by abandoning the collateral to the secured party (so that a foreclosure sale can occur under state law), or by retaining the collateral but distributing legal rights with a comparable value to the secured creditor. These two cram down options should be the same, from the perspective of the secured creditor." David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 8-9 (1996).

The wholesale standard should promote overall economic efficiency. The purpose of collateral is to serve as a source of payment for a secured loan in the event that the borrower defaults. Providing at least the value that a creditor could realize following repossession and resale of that particular collateral reflects that purpose. If a high valuation prevented retention of collateral, a debtor would forfeit the collateral to a creditor that would realize only the much lower foreclosure price if it repossessed and sold the property or forced a foreclosure sale. Thus, a higher valuation standard would force the transfer of property to a party that would yield a lower return for it. Wholesale valuation may be more economically efficient because the debtor will able to keep the property in those cases where the debtor values it most.[1297]

When determining how to calculate the amount of the allowed secured claim, it also is important to recognize the goal of the valuation exercise: an accurate valuation of the asset to capture the present value of the asset's future cash flows. Wholesale price is a much better approximation of the collateral's actual value because retail price reflects the an extra component of a retailer's value-adding attributes that are not relevant or appropriate in this context. This is especially true when the secured creditor is not a retailer in used goods and must sell the property to someone else for resale or must pay to add value itself.[1298] Even when the secured creditor is a retailer, there are very real expenses that the creditor must undertake to resell an item for a retail price that will not be expended when the debtor retains the property. The Supreme Court recognized this underlying economic reality in footnote six of its decision in *Rash*, and the Commission's Recommendation reflects this reality as well.

[1297] "[T]he highest valuing user enjoys the rest of the value as consumer surplus. . . That is what bankruptcy valuation is supposed to replicate, and the use of wholesale price does the job." *See In re* Hoskins, 102 F.3d 311, 320 (7th Cir. 1996) (Easterbrook, J. concurring).

[1298] "The distinction between wholesale and retail prices is a false one. Retail prices reflect value added by the retailer. If the cost of value added by the retailer were to be removed from retail value, the remainder would be wholesale value. Hence, wholesale is simply retail minus the transaction costs of retailing . . .these transaction costs ought to be removed. David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 8 (1996) "The retailer adds value to the transaction. The retailer maintains an inventory of automobiles, reducing the number of sites a buyer must visit to complete a transaction and thereby reducing the buyer's search costs. The retailer, like the securities dealer, also stands ready to buy and sell automobiles, thereby providing liquidity to the marketplace. A retailer also may provide explicit or implicit certifications of quality, perhaps through the retailer's reputation in the community." Robert M. Lawless & Stephen P. Ferris, *Economics and the Rhetoric of Valuation*, 5 J. BANKR. L. & PRAC. 3, 16-18 (1995) ("We believe that a value that approximates wholesale price should be the relevant measure of [lender]'s claim for purposes of the Chapter 13 cramdown . . . . Because the value of an automobile sold in the market at the wholesale level comes almost directly from the manufacturing activities of the dealer, the wholesale price of the automobile likely comes closest to representing the automobile's true worth").

Fair Market Value Minus Hypothetical Costs of Sale. Fair market value minus hypothetical costs of sale provides a parallel standard of valuation for real property.[1299] A number of circuit courts of appeals have adopted the fair market value standard for assessing the allowed secured claim on real property.[1300] The proposed approach diverges from some court decisions that have not deducted hypothetical costs of sale.[1301] Refusing to deduct hypothetical costs generally has been justified by the same arguments employed to support retail valuation of personal property: because these courts focus on the debtors' intended use of the property, *e.g.*, continued possession, they have found that it would be unreasonable to deduct costs when no sale is intended. Other courts sharply disagree with this premise. Instead, they base their inquiries on the creditor's interest in the property and note that a secured creditor could never realize fair market value without incurring disposition costs, and thus these must be factored into the valuation.[1302]

The Recommendation would deduct sales costs from the fair market price for several reasons. A fair market value standard properly sets the allowed secured claim at an amount that represents what a willing and fully informed buyer would pay under fair market conditions. It is the best approximation of the property's full market value and reflects that in the context of real property there is less difference between the price that a debtor and the price another party could obtain for the property outside the context of a foreclosure sale. Typically, there is no wholesale market for real estate. A wholesale approach to real estate, therefore, is "retail" less

[1299] This standard will not apply to mortgages on the primary residence of a Chapter 11 or 13 debtor retaining the residence since such mortgages are protected from modification. This standard presumably would apply, however, to personal property forms of holding other real property, such as land trusts.

[1300] *See, e.g.*, Taffi v. United States, 96 F.3d 1190 (9th Cir. 1996) (en banc), *cert. denied*, 117 S.Ct. 2478 (1997); *In re* Trimble, 50 F.3d 530 (8th Cir. 1995); Winthrop Old Farm Nurseries v. New Bedford Inst. for Sav., 50 F.3d 72 (1st Cir. 1995); *In re* McClurkin, 31 F.3d 401, 405 (6th Cir.1994). Cf. *In re* Balbus, 933 F.2d 246, 250-52 (4th Cir.1991) (where purpose of valuation was to determine whether debtor had too much unsecured credit to qualify as Chapter 13 debtor, and where debtor would retain house under plan, value of creditor's interest in house was amount creditor would receive at foreclosure sale).

[1301] *See, e.g.*,Taffi v. United States, 96 F.3d 1190 (9th Cir. 1996) (en banc), *cert. denied*. 117 S.Ct. 2478 (1997); *In re* Trimble, 50 F.3d 530 (8th Cir. 1995); Winthrop Old Farm Nurseries v. New Bedford Institution for Savings, 50 F.3d 72 (1st Cir. 1995); *In re* McClurkin, 31 F.3d 401, 405 (6th Cir.1994) (section 506(a) "does not require or permit a reduction in the creditor's secured claim to account for purely hypothetical costs of sale" of Chapter 13 debtor's residence).

[1302] *See, e.g.*, Bank of Am. v. 203 N. LaSalle St. Partnership, 195 B.R. 692 (N.D. Ill. 1996), *aff'g*, 190 B.R. 567 (Bankr. N.D. Ill. 1995) (valuing real property at its fair market value but deducting disposition costs), *aff'd*, No. 96-2137, No. 96-2138 (slip. op.) (7th Cir. September 29, 1997).

expenses, as *Rash* generally establishes. Although more numbers are used in the calculation, there is no other shorthand way to approximate wholesale value.

Fair market value less costs is also a compromise. Fair market value is higher than a foreclosure or forced sale price, but slightly less than a non-adjusted fair market price. Assuming that the price yielded at a foreclosure sale often is well below the fair market value, it provides a reasonable parallel approach to the wholesale standard because, like wholesale, this calculation is closer to fair market value than to liquidation value. This again offers a "compromise" valuation method that is easier to administer than another midpoint standard that would require two valuations.

Deducting costs of sale also better reflects a secured creditor's state law entitlement, which must be considered in this type of analysis.[1303] If the secured creditor foreclosed and exercised its state law remedies, its return would be far less than fair market value without cost adjustments.

In addition, section 506(c), which permits costs of sale to be surcharged to a secured creditors' collateral, supports the notion that costs of sale can diminish the return to a secured creditor.[1304] In a sale within bankruptcy, the costs of sale are deducted from the proceeds ahead of the recovery by the secured creditor. If the price received does not cover the costs of sale plus the full amount of the loan, the secured creditor's recovery is reduced, and the secured creditor's claim is bifurcated into its secured and unsecured portions. On the other hand, if the price received for the property is sufficient to cover both the costs of sale and the secured claim, then the secured creditor is protected in full. The Recommendation puts the secured creditor whose collateral is retained in the same position as the secured creditor whose collateral is sold.

A balance between secured and unsecured creditors is more fairly established when a creditor's allowed secured claim is adjusted for the costs it did not have to incur to be protected for the fair market price. Again, this permits all parties to participate and share in the benefits of the reorganization. Like with wholesale value, however, the parties who may be shortchanged by a fair market valuation are the unsecured creditors, who more likely would yield a greater return with a foreclosure sale valuation standard.

Competing Considerations. Some would criticize the wholesale and fair market standards as being too high. These standards, it has been argued, provide a

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[1303] *See* Butner v. United States, 440 U.S. 48 (1979).

[1304] David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 51 (1996).

windfall to secured creditors that bargained for and would receive only foreclosure value outside bankruptcy, where they also would have to bear the costs and burdens attendant to those collection activities. To the extent that distributions to unsecured creditors depend on valuation of collateral, the interests of unsecured creditors are harmed by these higher valuation standards.

Perhaps reflecting the pitfalls of any compromise approach, the recommended valuation standard has also been criticized for being too low. Some argue that wholesale valuation permits the debtor to obtain a windfall in the event that the debtor resold the property for retail price.[1305] The debtor generally will be ill-equipped to take the steps that add the requisite value that would be necessary to fetch a retail price, such as providing a warranty, reconditioning the property, offering credit terms, or offering the collateral for sale in a well-located shopping area.[1306] More significantly, this circumstance is economically unlikely in a competitive market, according to some scholars and economists: "[i]f such opportunities did exist, we would expect to see persons enter the market to take advantage of them. These new market entrants would bid up the wholesale price until it eventually equaled the retail price."[1307] The reason a difference exists between wholesale and retail, they explain, is that value is added at the retail level.

Some have argued that a different policy issue should be reflected in the valuation standard. They argue that property valuation should offset the risk of loss to the creditor. According to this argument, valuation should be high because it may be inaccurate or because the value may decline—in effect, the valuation standard should provide a cushion for secured creditors. The Bankruptcy Code addresses risk issues, but it uses different statutory means. It provides for compensation for risk of loss through other provisions, such as adjustment of the amortization rate, adjustment of the interest rate, calculation of adequate protection payments, or changes in other terms of the agreement. By using these devices, the question of risk is squarely presented, not buried in a broad—and deliberately distorted—rule of valuation. The Code's current approach is more accurate because it is based on actual risk, not some universally-presumed risk incorporated into a valuation standard applicable to all debtors and all situations.

Some have questioned whether the costs of sale should be deducted from the fair market value of real property. It might be improper to allocate the hypothetical

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[1305] Associates Commercial Corp. v. Rash, 31, F.3d 325 (5th Cir. 1994), *aff'd on rehearing en banc*, 90 F.3d 1036, *rev'd*, 117 S. Ct. 1879 (1997).

[1306] Robert M. Lawless & Stephen P. Ferris, *Economics and the Rhetoric of Valuation*, 5 J. BANKR. L. & PRAC. 3, 18 (1995) (consumer debtor, as one-time dealer, cannot provide services to marketplace that would permit her to charge higher retail price).

[1307] *Id.* at 5 (1995).

costs to the creditor when, outside of bankruptcy, such costs might be added to a debtor's deficiency and not deducted from the first dollar of proceeds from the sale.[1308] However, the rule proposed here exactly mirrors the non-bankruptcy rule: in bankruptcy, the claim is simply bifurcated into its secured and unsecured portions. In or out of bankruptcy, the secured creditor bears the costs of its loan plus the costs of resale, and it must seek a deficiency for whatever costs that sale of the collateral will not cover. In bankruptcy, the deficiency remains the same; it merely becomes an unsecured claim.[1309] Because creditors bear initial responsibility for the costs of sale outside bankruptcy, deducting these hypothetical costs from the allowed secured claim best comports with reality under state law and prevents a greater burden from being shouldered by the unsecured creditors.

[1308] *In re* McClurkin, 31 F.3d 401, 404 (6th Cir. 1994).

[1309] *See* U.C.C. § 9-504(1)(a). *See generally* David Gray Carlson, *Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases*, 13 BANKR. DEV. J. 1, 59 n.187 (1996) (noting that positive transaction costs reduce amount secured party obtains from *collateral*, to which size of deficit is unrelated).

II. Third Party Effects of Business Bankruptcy

As a collective proceeding, bankruptcy involves a multiplicity of parties, more than are involved in the routine debt collection process. The effects of bankruptcy inevitably go beyond direct relationships between the bankruptcy estate and its creditors. In a complex Chapter 11 case, several third party relationships are affected. As part of the reorganization, property of the estate might be sold to third parties who had no prior dealings with the debtor or its creditors. Nondebtor parties who have guaranteed some of the debtor's obligations might agree to contribute funds to the reorganization in exchange for a global, non-litigated resolution. Sometimes, the bankruptcy process disrupts relationships between the debtor's employees and the employees' creditors when the debtor holds portions of employees' wages for payment to those parties. Although the broad nature of bankruptcy jurisdiction reflects that a variety of third party dealings might be related to the reorganization process, substantive bankruptcy law does not provide adequate guidance for many of these dealings. Several of the Commission's recommendations attempt to clarify these issues and produce a fairer and more efficient system.

2.4.12 *Clarifying the Conditions for Sales Free & Clear Under 11 U.S.C. § 363(f)*

Congress should make clear that bankruptcy courts can authorize sales of property of the estate free of creditors' interests regardless of the relationship between the face amount of any liens and the value of the property sold.

A business can reorganize its affairs in part by selling certain pieces of unnecessary property while using sales proceeds to fund a reorganization plan intended to pay its creditors. The Bankruptcy Code specifically allows the bankruptcy court to approve sales of property of the estate.[1310] Even if the property to be sold is encumbered with liens or security interests, a longstanding component of the bankruptcy system is the ability to sell property to a third party free and clear of liens and interests.[1311] The reasoning behind this is plain: unencumbered property will yield a higher sales price, while the holder of the released interest is fully protected by

[1310] 11 U.S.C. § 363(b) (1994) (authorizing sales outside ordinary course of business).

[1311] *See* Michael H. Reed, *Successor Liability and Bankruptcy Sales*, 51 BUS. LAW. 653, 656 (1996), *citing* Van Huffel v. Harkelrode, 284 U.S. 225, 227 (1931) (bankruptcy courts inherently had power to permit assets to be sold free and clear).

having the lien or security interest attach to the proceeds.[1312] The secured party either will receive its share of the proceeds from the sale, the lien will attach to proceeds retained by the estate, or the creditor can credit bid on the property by bidding in some or all of the value of its lien against the property of the debtor.[1313] If the creditor's lien attaches to the proceeds, the estate can use the proceeds only if adequate protection is provided under section 363(e).

This concept of the free and clear sale was incorporated into section 363(f) of the Bankruptcy Code with five conditions listed.[1314] The debtor need not meet all five conditions; if one condition is satisfied, the court can enter an order that the sale is free and clear of prior liens and interests.[1315] For example, under section 363(f)(2), property can be sold free and clear with the consent of the holders of those interests. Under section 363(f)(4), property can be sold free and clear of an interest that is in "bona fide dispute," even if the interest holder does not consent. Likewise, section 363(f)(1) provides that property can be sold free and clear of interests if applicable law would permit a free and clear sale, a seemingly broad provision in itself that does not necessarily consider the legitimacy of the interest or the consent of the interest holder.

However, the conditions set forth in section 363(f)(3) and (f)(5) have been the sources of a sharp split in the case law, which, in turn has provided inadequate guidance for parties attempting to settle disputes. These provisions raise questions about how to proceed with a potential sale when the debt secured by liens or interests

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[1312] *See* Wright v. Union Cent. Life Ins. Co., 311 U.S. 273 (1940), *reh'g denied*, 312 U.S. 711 (1941) (safeguards were provided to protect rights of secured creditor to protect value of property, but no constitutional claim to more).

[1313] "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property." 11 U.S.C. § 363(k) (permitting creditors to "credit-bid" at sales). *See* United States Trustee v. Messer (*In re* Pink Cadillac Assoc.), No. 96-4571, 1997 WL 164282 (S.D.N.Y. Apr. 8, 1997) (secured creditor credit bidding on property at auction).

[1314] Section 363(f) provides that "[t]he trustee may sell property under subsection (b) or (c) of this section free and clear of any interest in such property of an entity other than the estate, only if- (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest; (2) such entity consents; (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property; (4) such interest is in bona fide dispute; or (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." 11 U.S.C. § 363(f) (1994).

[1315] *See* 3 COLLIER ON BANKRUPTCY ¶ 363.06[1]) (Lawrence P. King et al. eds. rev. 15th ed. 1996) (list of conditions in section 363(f) is disjunctive).

exceeds the value of the collateral. This is a common scenario in bankruptcy cases, particularly in Chapter 7 and Chapter 11 cases.

Section 363(f)(3) authorizes a sale free and clear if "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property."[1316] This language is ambiguous and it is capable of yielding two distinct interpretations.

Some courts and commentators have read this language to permit a sale free and clear only if the sales price exceeds the aggregate face amounts of the liens, i.e., when the secured creditor is *over*secured. As these courts see it, the estate has little to gain from managing the sale and selling property free and clear of liens when the lienholders will be entitled to all proceeds.[1317]

Several practical consequences flow from this interpretation. If both an oversecured and an undersecured lien encumber a piece of property that is declining in value, the second lienholder can withhold consent, prevent the bankruptcy sale, and force the estate to abandon the property to the debtor.[1318] The property then will be sold in a state law foreclosure sale. State foreclosure sales typically yield lower prices than bankruptcy sales.[1319] The price often is so low because the holdout undersecured

[1316] Bankruptcy Amendment and Federal Judgeship Act of 1984, Pub. L. No. 98-353 § 442(d) (1984). Initially under the Bankruptcy Code of 1978, section 363(f)(3) authorized a sale free and clear of a lien if the sale price was greater than the value of "such interest" in the property.

[1317] "The theory is that the trustee should not need to sell a property free of liens if the proceeds of the sale will be earmarked for lienholders anyway, and the estate will receive no benefit from the sale, unless there is some other basis for such a sale under section 363(f)." 3 COLLIER ON BANKRUPTCY ¶ 363.06[1]) (Lawrence P. King et al. eds. 15th ed. 1996), *citing In re* Riverside Inv. Partnership, 674 F.2d 634 (7th Cir. 1982). *See also* Morgan v. K.C. Machine & Tool Co. (*In re* K.C. Machine), 816 F.2d 238, 243 (6th Cir. 1987); *In re* Terrace Chalet Apts., 159 B.R. 821 (N.D. Ill. 1993); *In re* Heine, 141 B.R. 185 (Bankr. S.D. 1992); *In re* Julien Co., 117 B.R. 910 (Bankr. W.D. Tenn. 1990); *In re* Stroud Wholesale, Inc., 47 B.R. 999 (E.D.N.C. 1985), *aff'd without opinion*, 983 F.2d 1057 (4th Cir. 1986). Taking a cue from other Code provisions, they conclude that Congress would have continued to refer to "interest" had it intended to denote the concept of actual value rather than specifically departing from the use of that term in 1984. For example, section 506(a) refers to "the extent of the value of such creditor's *interest*," a concept that now is absent from section 363(f)(3).

[1318] *See* 11 U.S.C. § 554(a) (1994) (permitting trustee to abandon property of estate that is "burdensome" or that is of "inconsequential value and benefit" to estate after notice and hearing).

[1319] Armstrong v. Csurilla, 817 P.2d 1221 (N.M. 1991) (discussing low prices that foreclosure sales often bring and when they can be deemed inadequate); Alvin C. Harrell, *UCC Article 9 Drafting Committee Considers October 1996 Draft*, 51 CONSUMER FIN. L. Q. REP. (1997) (reporting that committee met to discuss low price foreclosure sales, among other issues); Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B, and 9 Be Fair to* creditor will make a low bid on the property in the likely absence of other bidders.[1320] Foreclosure does not mark the end of the collection process for many creditors. A creditor on a recourse loan can also claim its deficiency judgment, which nearly always will be greater than if the property had been sold in bankruptcy. The difference between the foreclosure sale price and the otherwise higher bankruptcy sale price comes directly out of the pockets of the other unsecured creditors of the estate. This example illustrates that the estate can have a strong interest in the sale of property even if it will not receive any proceeds directly. The estate will be injured if an individual undersecured creditor extracts a premium by holding out or preventing a bankruptcy sale.

Taking a different path in their statutory and policy analyses, other courts and commentators interpret section 363(f)(3) to protect only the actual economic value of the liens and thus permit a sale free and clear regardless of whether the secured

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Consumers?, 75 WASH. U.L Q. 69, 133, 137 (1997) (noting continual problem of sales yielding values at far less than market price, citing studies of low disposition prices in consumer sales), *citing* David B. McMahon, *Commercially Reasonable Sales and Deficiency Judgments Under UCC Article 9: An Analysis of Revision Proposals*, 48 CONSUMER FIN. L.Q. REP. 64 (1994); Lynn M. LoPucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 WIS. L. REV. 311, 320-21, n.52 (sales procedures used by bankruptcy courts are "vastly superior to those employed in the state remedies subsystem”). These sales must be conducted in a commercially reasonable fashion procedurally, but are not required to yield a commercially reasonable price. To challenge sales on the basis of inadequate price, the price received must be so low as to "shock the conscience." Gottlieb v. McArdle, 580 F. Supp. 1523, 1525 (E.D. Mich. 1984), *citing* United States v. Wells, 403 F.2d 596 (5th Cir. 1968); Golden v. Tomiyasu, 387 P.2d 989, 992 (Nev. 1963). *See* Federal Deposit Ins. Corp. v. Blanton, 918 F.2d 524, 531 (5th Cir. 1990) (Texas caselaw authority suggesting that sale of property for slightly more than 60% of fair market value was not so grossly inadequate as to be commercially unreasonable), *reh’g denied*, 923 F.2d 851 (5th Cir. 1991).

[1320] *See* Donald J. Rapson, *Deficient Treatment of Deficiency Claims: Gilmore Would have Repented*, 75 Wash U.L.Q. 491 (1997) (urging adoption of rule dealing with prevalent tendency for secured parties to bid on collateral in foreclosure sales for far less than fair market value and then collect significant deficiency judgment). "[T]here is a positive incentive for [secured creditor] to buy at below the fair foreclosure value of the collateral. In all three cases, the actual "price" paid at the foreclosure sale is economically irrelevant to them except as it fixes the amount of deficiency. The lower the foreclosure sales price paid, the larger the deficiency which may be recovered from the debtor. And there is an opportunity for the secured party, recourse party, or related party to sell the collateral at a price which nets them more, sometimes substantially more, than the price they bid at the foreclosure sale.” Gail Hillebrand, *The Uniform Commercial Code Drafting Process: Will Articles 2, 2B, and 9 Be Fair to Consumers?*, 75 WASH. U.L.Q. 69 (1997). "[T]he only bidder at 99% of foreclosure sales is the mortgagee.... State foreclosure laws have failed to adequately protect the debtor from low sales prices. The statutory notice requirements generate little interest and most mortgagees have little incentive to advertise." Robert Burford, *Can Mortgage Foreclosure Sales Really be Fraudulent Conveyances Under Section 548(a)(2) of the Bankruptcy Code?*, 22 HOUS. L. REV. 1221, 1248 (1985).

creditor is oversecured or undersecured.[1321] This approach is consistent with the requirements for Chapter 11 cramdown plans under section 1129(b)(2)(A).[1322] For those taking this view, section 363(f)(3) merely recognizes that the sale price must be commercially reasonable, in which case the proceeds reflect the market value of the lienholder's liens.[1323] Thus, overencumbered property of the estate can be sold in a structured and supervised bankruptcy sale free and clear rather than abandoned to undersecured creditors to be sold in a state law foreclosure sale. No harm should befall the undersecured lienholder in a bankruptcy sale free and clear because, unless the court ordered otherwise, the creditor can bid on the property in the bankruptcy sale if it wants to hold onto its property interest with the belief that the value of the collateral will appreciate. Because the Bankruptcy Code permits the creditor to bid its claim rather than requiring cash for any amount in excess of a superior lien, it is protected from any losses due to an inaccurate valuation.

The Commission recommends a resolution to the case law conflict that best comports with policy considerations. The Commission recommends that section 363(f)(3) should not preclude a sale free and clear of property solely because the lienholders are undersecured. Consideration of the value of the liens in relation to the property value should not be a factor in determining whether property can be sold free and clear of claims and interests. Thus, a commercially reasonable sale would satisfy the condition imposed by section 363(f)(3). This interpretation brings section 363(f) in line with sales under section 1129(b).[1324] To effectuate this interpretation, section 363(f) should be redrafted to reflect this clarification. Due to of the structure of section 363(f), which precludes sales free and clear unless one of five conditions is satisfied, subsection (3) cannot simply be eliminated, because the provision would become more restrictive on reasonable sales, not less.

Under the Commission's Recommendation, the parties can proceed with a sale free and clear in bankruptcy where the estate otherwise might be forced to abandon

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[1321] *See In re* Oneida Lake Dev., Inc., 114 B.R. 352, 356 (Bankr. N.D.N.Y. 1990) (Subsection (f)(3) reference to value must be defined by reference to section 506(a), defining secured status as extending only to 'value of such creditor's interest in such property,' thus negating contention that value is determined by looking solely at face amount of lien in analyzing section 363(f)(3)); *In re* Collins, 180 B.R. 447, 451 (Bankr. E.D. Va. 1995), *citing* United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assoc., 484 U.S. 365, 369 (1988) (section 506(a) definition of value has same meaning as in sections 361 and 362); *In re* Beker Indus. Corp., 63 B.R. 474 (Bankr. S.D.N.Y. 1986); *In re* Milford Group, Inc., 150 B.R. 904 (Bankr. M.D. Pa. 1992); *In re* WPRV-TV, Inc., 143 B.R. 315, 320, *aff'd in part, rev'd in part, rev'd on other grounds*, 983 F.2d 336 (1st Cir. 1993).

[1322] *Beker*, 63 B.R. at 477.

[1323] *In re* BFP v. Resolution Trust Corporation, 511 U.S. 531 (1994).

[1324] *See* 11 U.S.C. § 1129(b)(2)(A)(ii) (1994).

the property. The estate and other creditors will benefit when a sale yields a higher price for the property and keeps the lienholder's deficiency judgment to its minimum.

This change would resolve a source of confusion that unnecessarily provokes litigation. The amendment therefore has the potential to increase the speed of Chapter 11 proceedings, focus the parties' energies on reorganization and distribution, and enhance the returns in section 363 sales.

By speaking to the valuation question that inheres in section 363(f)(3), however, this Proposal does not change any of the other considerations that might factor into a decision to hold a sale free and clear. For example, if the property is not necessary to an effective reorganization and the debtor has no equity in the property, a court might lift the automatic stay to allow the secured creditor to pursue nonbankruptcy remedies rather than order a bankruptcy sale.[1325] Likewise, a court may choose not to order a sale free and clear in a nonbusiness Chapter 7 case when the estate would truly gain nothing from the sale and when the quicker bankruptcy sale would serve only to hasten termination of the interests of junior interests and the debtor without protective procedures that state foreclosure law might otherwise provide. The Commission's Proposal does not change or minimize any of these considerations.

Interrelation with Subsection 363(f)(5). Section 363(f)(3) often is interpreted in conjunction with section 363(f)(5), which has added further to the confusion. Section 363(f)(5) permits a sale free and clear if "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." Under this subsection, the court can order a sale free and clear if the holder of an interest could be compelled under nonbankruptcy law to accept monetary payment. Section (f)(5) addresses a wider scope of interests in property than section 363(f)(3) because it includes other interests in addition to liens. Thus, if parties seek to sell property free and clear of other types of rights or covenants, the court must determine that the holders of those interests could otherwise be compelled to accept money satisfaction.[1326] When applied to liens, however, the condition easily would be met if literally interpreted.

Uneasy about the consequences of such a broadly applicable condition as applied to liens, some courts have inserted a valuation component with varying

[1325] *See* 11 U.S.C. § 362(d)(2) (1994).

[1326] *See, e.g., In re* 523 E. Fifth St. Hous. Preservation Dev. Fund Corp., 79 B.R. 568 (Bankr. S.D.N.Y. 1987) (cannot sell property free and clear of restrictive covenants); *In re* WBQ Partnership, 189 B.R. 97 (Bankr. E.D. Va. 1995) (property could be sold free and clear of statutory right to recover depreciation overpayments from purchaser); *In re* Crabtree, 112 B.R. 420 (Bankr. W.D. Okla. 1989) (oil and gas interests).

results.[1327] According to some of these courts, the reference in subsection (f)(5) to "money satisfaction" means "*full* money satisfaction," and thus the lienholders must be oversecured to trigger this provision,[1328] unless "equitable considerations" support extinguishing an undersecured lien.[1329] By this reading, subsection (5) is a restatement of some courts' interpretation of subsection (3).

Other courts hold that subsection (f)(5) comes into play only for undersecured creditors, because they also believe that subsection (f)(3) is the applicable provision to consider when the interest is oversecured. This differs from the interpretation recommended by the Commission.[1330] Some courts have concluded that subsection (f)(5) authorizes a sale free and clear of an undersecured lien only if the circumstances would satisfy the requirements for cramdown under section 1129(b)(2), on the grounds that a cramdown is analogous to a sale producing less than full compensation for the undersecured creditors.[1331] In taking that approach, one court acknowledged that the Code did not quite support this result, but that this reading was better than alternative interpretations.[1332] As an interesting final twist, this conclusion on the interpretation of subsection (f)(5) has been used to support, in turn, the argument that (f)(3) must protect the full face amount of liens, to avoid an end run around the imputed requirements of subsection (f)(5).[1333]

While this analysis may be circular, the case law shows that subsection (f)(5) has been interpreted to address the same valuation issues as subsection (f)(3) when

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[1327] *Heine*, 141 B.R. at 189 (analyzing "equitable interests" in determining whether to permit sale free and clear under subsection (f)(5)).

[1328] *In re* General Bearing Corp., 136 B.R. 361 (Bankr. S.D.N.Y. 1992) (requiring full money satisfaction for sale free and clear under both subsections (f)(5) and (f)(3) of 363).

[1329] *Stroud Wholesale*, 47 B.R. at 1003 (full money satisfaction required in liquidation cases, otherwise subsections (1) through (4) would be meaningless); *In re* Wing, 63 B.R. 83, 85 (Bankr. M.D. Fla. 1986).

[1330] *In re* Healthco Int'l, Inc., 174 B.R. 174, 176 (Bankr. D. Mass. 1994); Terrace Chalet Apartments, Ltd., 159 B.R. 821, 827 (Bankr. N.D. III. 1993); *In re* Perroncello, 170 B.R. 189, 191 (Bankr. D. Mass. 1994).

[1331] *See In re* Grand Slam, 178 B.R. 460 (E.D. Mich. 1995); *Terrace Chalet*, 159 B.R. at 827, *citing In re* Weyland, 63 B.R. 854, 860- 61 (Bankr. E.D. Wis. 1986); *In re* Hunt Energy Co., 48 B.R. 472, 485 (Bankr. N.D. Ohio 1985), *aff'd in part and rev'd in part*, 1988 U.S. Dist. Lexis 14295 (N.D. Ohio June 29, 1988); *In re* Red Oak Farms, Inc., 36 B.R. 856, 858 (Bankr. W.D. Mo. 1984); *In re* WPRV-TV, Inc., 143 B.R. 315, 320, *aff'd in part, rev'd in part, rev'd on other grounds*, 983 F.2d 336 (1st Cir. 1993).

[1332] *Healthco*, 174 B.R. at 176.

[1333] *Perroncello*, 170 B.R. at 191, *citing Terrace Chalet*, 159 B.R. at 827.

applied to liens. This provision's imputed valuation guidelines become irrelevant under the interpretation of section 363(f)(3) that the Commission endorses. That view would allow bankruptcy courts to permit sales of property of the estate free of creditors' claims regardless of the relationship between the face amount of liens and the value of the property sold. While the provision may serve a purpose in assessing the treatment of other types of interests, it should not be used to address questions of valuation and liens.

Competing Considerations. Some might believe that property should not be sold free and clear if the secured creditors will not be fully paid out of the proceeds. However, as stated previously, the right to credit bid for the property protects the creditor, and the bankruptcy system has long recognized that sales free and clear are appropriate as long as the secured creditor's interest is protected.

Others might be concerned about the estate bearing the costs of sale without prospects of receiving any direct proceeds. This Proposal would not require a bankruptcy sale and would not preclude abandonment if the court and the trustee deemed it appropriate. However, in many cases, a bankruptcy sale will be superior to abandonment and foreclosure sale from the estate's perspective. This Proposal does not address who should bear the costs of a sale free and clear.[1334] Section 506(c) permits the trustee to recover disposition costs from a secured party. Whether section 506(c) should be further clarified or expanded is an open question that several Commissioners have suggested would be legitimate to consider.

2.4.13 *Release of Claims Against Nondebtor Parties*

Congress should amend sections 1123 and 524(e) to clarify that it is within the discretion of the court to allow a plan proponent to solicit releases of nondebtor liabilities. Creditors that agree in a separate document to release nondebtor parties will be bound by such releases, whereas creditors that decline to release their claims against nondebtor parties will not be bound to release their claims.

The successful rehabilitation of a business almost always requires the discharge of all or some of the debtor's liability for prepetition claims.[1335] However, the liability of nondebtor parties for certain debts can have an equally large impact on the ability of a debtor business to reorganize and pay its creditors. For example, guarantors of the debtor's debts might agree to contribute significant capital to help fund the plan of reorganization and repayment of creditors in exchange for a release

[1334] *See, e.g., In re* James, 203 B.R. 449 (Bankr. W.D. Mo. 1997) (paying auctioneer's fee out of sales proceeds as necessary to administration of estate and only funds available for payment).

[1335] *See* 11 U.S.C. §§ 524, 1141 (1994) (providing for discharge).

of liability for guaranteed debts. Key managers and directors with experience with the debtor might agree to stay on, which may be a determining factor in whether the plan is feasible.[1336] Parties may be involved in complex litigation with the debtor's principals, which unavoidably would involve the reorganized debtor. Those parties might settle claims in exchange for releases from creditors holding claims against them, saving the debtor significant amounts in new legal fees. Among the types of nondebtor liabilities that a creditor might agree to release include lender liability claims, ERISA claims, director and officer shareholder litigation, and insurance and co-liability claims in both tort and contract. Whether as part of a plan or reorganization or incorporated in a settlement agreement, creditors are in the best position to determine whether they will benefit from the release of their claims against third parties through the bankruptcy process. Use of the bankruptcy system in this context can eliminate piecemeal litigation and curb costs significantly.

Current law offers little guidance to the parties and the courts on whether nondebtor release provisions may be included in a settlement or plan of reorganization and subsequently enforced by an injunction.[1337] The problem is exacerbated by a statutory conflict that arises primarily through the interpretation of two provisions of the Bankruptcy Code. Section 524(e) provides that the "discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." Based in part on this language, some courts have held that bankruptcy courts lack the power or the jurisdiction to prevent a creditor from enforcing a judgment against a nondebtor party.[1338]

[1336] 11 U.S.C. § 1129(a)(11) (1994) (requiring that plan be feasible).

[1337] *See* Ralph R. Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Nondebtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. (forthcoming) (absent specific Congressional authorization, Code does not provide authority to bankruptcy judges to approve nondebtor releases); Kenneth M. Lewis, *When Are Nondebtors Really Entitled to a Discharge: Setting the Record Straight on Johns-Manville and A.H. Robins*, 3 J. BANKR. L. & PRAC. 163 (1994).

[1338] *See* Resorts Int'l, Inc. v. Lowenschuss, 67 F.3d 1394 (9th Cir.) (reaffirming Ninth Circuit rule that Bankruptcy Code does not authorize release of nondebtor parties) *cert. denied,* 1165 S. Ct. 2497 (1995); American Hardwoods, Inc. v. Deutsche Credit Corp., 885 F.2d 621, 626 (9th Cir. 1989) (section 524(e) precludes bankruptcy courts from discharging liabilities of nondebtors, and "the specific provisions of section 524 displace the court's equitable powers under section 105 to order the permanent relief"); Underhill v. Royal, 769 F.2d 1426 (9th Cir. 1985) (even if creditors consent, bankruptcy court not empowered to discharge liabilities of nondebtors); Landsing Diversified Properties-II v. First Nat'l Bank and Trust Co. of Tulsa, 922 F.2d 592, 600 (10th Cir. 1990)("Congress did not intend to extend such benefits to third-party bystanders"), *modified sub nom*. Abel v. West, 932 F.2d 898 (10th Cir. 1991). *See generally* Judith R. Starr, *Bankruptcy Court Jurisdiction to Release Insiders from Creditor Claims in Corporate Reorganizations,* 9 BANKR. DEV. J. 485, 487 (1993); Peter M. Boyle, *Non-Debtor Liability in Chapter 11: Validity of Third-Party Discharge in Bankruptcy*, 61 FORDHAM L. REV. 421 (1992) (Code precludes nondebtor discharge).

Other courts, however, have concluded that the statute does not impose a *per se* rule against permitting and enforcing third party releases.[1339] Bankruptcy courts may have the power to release claims against nondebtor parties under their all-writs power codified in section 105, which authorizes the court to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions of this title."[1340]

Among the courts that do not dismiss out of hand the possibility of nondebtor releases, a variety of different substantive rules to govern third party releases in the bankruptcy reorganization process, resulting in uncertainty and complexity. Some courts will authorize the release of claims if the majority of affected creditors support such a release and will force dissenting minority creditors to release their claims as well.[1341] Other courts have declined to confirm plans providing for nondebtor releases

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[1339] *See In re* Specialty Equip. Co., 3 F.3d 1043, 1047 (7th Cir.1993) (statute does not preclude all nondebtor releases that are accepted and confirmed as integral part of reorganization, for court may discharge nondebtor with consent); *In re* A.H. Robins, Inc., 880 F.2d 694, 702 (4th Cir.) (permitting release of nondebtor insurers when claimants had opportunity to opt out of settlement, and 94% of tort claimants affected by injunction voted to accept plan), *cert. denied*, 493 U.S. 959 (1989); *In re* Monarch Capital Corp., 173 B.R. 31, 43 (D. Mass. 1994) (section 524(e) does not limit court power under section 105(a) to enjoin actions against third parties), *aff'd sub nom.* 65 F.3d 973, 980 (1st Cir. 1995). *See also In re* AOV Indus., Inc., 792 F.2d 1140 (D.C. Cir.) (recognizing viability of third party release), *vacated on other grounds*, 797 F.2d 1004 (D.C. Cir. 1986); Feld v. Zale Corp., 62 F.3d 746 (5th Cir. 1995) ("related to" jurisdiction over third party actions arises when subject of dispute is property of estate or because dispute over asset would have effect on estate), *citing* Pacor, Inc. v. Higgins, 743 F.2d 984, 994 (3d Cir. 1984) (action is related to bankruptcy if outcome could alter debtor's rights, liabilities, options, or freedom of action). *See generally* Hydee R. Feldstein, Reinterpreting Bankruptcy Code Section 524(e): The Validity of Third Party Releases in a Plan, 68th Ann. Mtg. of Nat'l Conf. of Bankr. Judges 6-63 (1994) (third party releases are permissible under statutory language and are within bankruptcy court discretion. Objecting creditors should be bound by release of nondebtors if part of confirmable plan or approvable compromise."); John E. Swallow, *The Power of the Shield - - Permanently Enjoining Litigation Against Entities Other Than the Debtor -- A Look at In re A.H. Robins, Co.*, 1990 BYU L. REV. 707 (1990) (third party releases permissible under certain circumstances).

[1340] 11 U.S.C. § 105(a) (1994). *See also* Helen H. Han, *Testing the Limits of Judicial Discretion in Chapter 11: The Doctrine of Necessity and Third Party Releases*, 1994 ANN. SURV. AM. L. 551 (broad equitable powers of section 105(a) validate third party releases under certain circumstances).

[1341] *See, e.g.*, Shearson Lehman Bros., Inc. v. Munford, Inc., 97 F.3d 449, 454 (11th Cir. 1996) (using section 105(a) and FED. R. CIV. P. 16(c)(9) to enjoin actions by nonsettling defendants against nondebtor consulting firm); MacArthur Co. v. Johns-Manville Corp., 837 F.2d 89 (2d Cir.) (because insurance policies and rights under policies were part of debtor's estate, section 105(a) empowered court to channel and release claims against insurer in exchange for contributions over objections of co-insured party that wanted to retain its rights against insurer), *cert. denied*, 488 U.S. 868 (1988); *In re* Dow Corning Corporation, 198 B.R. 214, 243-246 (Bankr. E.D. Mich. 1996) (over objections of tort claimants committee, approving settlement whereby debtor compromised insurance that bind nonconsenting parties by a majority vote.[1342] However, many courts, including those that have rejected releases of objecting creditors' third party claims, have suggested that consensual releases are permissible.[1343] The possibility of consensual releases also raises the question of whether the debtor or the third party can offer greater compensation to creditors willing to release their claims.[1344]

To end the threshold legal dispute, the Commission recommends that the Bankruptcy Code provide for third party releases, but with limitations on their use.

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claims and released nondebtor insurance carriers because insurance policies are property of estate, and because debtor can dispose of property free and clear of liens and interests); *In re* Master Mortgage Inv. Fund, Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994) (over objections of Securities and Exchange Commission, holding that section 105 permits release of nondebtor in exchange for substantial contribution when overwhelming majority voted for plan); *In re* Drexel Burnham Lambert Group Inc., 138 B.R. 723 (Bankr. S.D.N.Y. 1992) (permitting releases of nondebtors whose contributions were essential to success of plan and retention of employees); *In re* Texaco, Inc., 84 B.R. 893 (Bankr. S.D.N.Y.) (confirming plan releasing derivative claims), *appeal dismissed as moot*, 92 B.R. 38 (S.D.N.Y. 1988).

[1342] *See In re* Forty-Eight Insulations, Inc., 149 B.R. 860 (N.D. Ill. 1992) (disallowing nonconsensual release of claims against insurer because contract rights of claimant to sue insurer were not property of bankruptcy estate); *In re* Arrowmill Dev. Corp., 211 B.R. 497 (Bankr. D.N.J. July 24, 1997) (no authority or policy justification to force dissenting creditors to release claims against nondebtor parties, but consensual releases can be enforced like any other settlement); *In re* U.S. Brass Corp., No. 94-40823 (Bankr. E.D. Tex. May 17, 1995) (disclosure statement disapproved for attempt to release third party liabilities over creditors' objections); *In re* West Coast Video Enters., Inc., 174 B.R. 906 (Bankr. E.D. Pa. 1994) (could not release former franchisee's claims against principals of debtor without their affirmative vote on plan); *In re* Boston Marina Harbor Co., 157 B.R. 726 (Bankr. D. Mass. 1993) (disallowing releases purporting to be binding on creditors voting against plan and release for lack of contractual basis); *In re* Keller, 157 B.R. 680 (Bankr. E.D. Wash. 1993) (denying plan confirmation for plan releasing liens against nondebtor's property being transferred under plan over creditor objection); *In re* 222 Liberty Assocs., 108 B.R. 971, 996 (Bankr. E.D. Pa. 1990) (plan nonconfirmable when releasing dissenting creditor's claims against nondebtor); *In re* Elsinore Shore Assoc., 91 B.R. 238, 252 (Bankr. D.N.J. 1988) (Bankruptcy Code prohibits involuntary releases for nondebtors, even if they contribute to plan); *In re* B.W. Alpha, Inc., 89 B.R. 592, 595 (Bankr. N.D. Tex.) (plan not confirmable that releases objecting creditors' claims against guarantors), *aff'd*, 100 B.R. 831 (N.D. Tex. 1988).

[1343] *See, e.g.,In re* Arrowmill Dev. Corp., 211 B.R. 497 (Bankr. D.N.J. July 24, 1997) (consensual releases can be enforced like any other settlement); *In re* West Coast Video Enters., Inc., 174 B.R. 906 (Bankr. E.D. Pa. 1994) (creditors can individually affirm release of nondebtor parties); *In re* 222 Liberty Assocs., 108 B.R. 971, 996 (Bankr. E.D. Pa. 1990) (plans that permit creditor to make individual decision to release claims against nondebtor parties are permissible); *In re* Monroe Well Serv., Inc., 80 B.R. 324 (Bankr. E.D. Pa. 1987) (consensual release of nondebtor parties that helped to fund plan permitted).

[1344] *See In re* AOV Indus., Inc., 792 F.2d 1140 (D.C. Cir.) (suggesting that creditors who released nondebtor claims should receive higher distribution to keep plan from providing disparate treatment), *vacated on other grounds*, 797 F.2d 1004 (D.C. Cir. 1986).

First, the Commission's Recommendation would permit only voluntary releases.[1345] It will not suffice that a creditor votes affirmatively for a plan that expressly provides for the release of nondebtor liabilities.[1346] To be bound by a release, a creditor would have to indicate its willingness to make an informed release of its claim against the third party. The release would be separate from its vote on a plan of reorganization. This means that the majority of a class could not bind a dissenting creditor and force it to release its claim.

This approach should be satisfactory to government agencies that frequently encounter this issue in bankruptcy cases, such as the Pension Benefit Guaranty Corporation, which often seeks carveouts from releases, and the Securities and Exchange Commission, which routinely objects to attempts to release nondebtor liability through bankruptcy absent actual consent.[1347] As long as the creditor, including a government agency, has the option to refuse to release its claim and not to be bound by any majority vote of its class, these government entities should not oppose this Proposal.

Nondebtor releases also would have to be necessary for the confirmation of a plan of reorganization. If they were not, the parties would not need the bankruptcy court and the bankruptcy forum to make these arrangements.[1348] For this reason, the validity of nondebtor releases should be subject to court review. Some courts have looked to whether a third party suit would deplete assets necessary for the reorganization, whether enjoining actions against certain third parties would significantly aid the reorganization, or whether the nondebtor would contribute substantial assets or otherwise add value to the reorganized enterprise.[1349] These are

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[1345] *See* Peter E. Meltzer, *Getting out of Jail Free: Can the Bankruptcy Plan Process Be Used to Release Nondebtor Parties?*, 71 AM. BANKR. L.J. 1, 40 (Winter 1997) ("validity of the release . . . hinge[s] upon principles of straight contract law or quasi-contract law rather than upon the bankruptcy court's confirmation order").

[1346] *In re* Arrowmill Dev. Corp., 211 B.R. 497, 506 (Bankr. D.N.J. 1997).

[1347] Letter from Richard H. Walker, General Counsel, Securities and Exchange Commission to National Bankruptcy Review Commission 2 (Apr. 15, 1997) ("The Chapter 11 Working Group's proposal is, in many respects, consistent with our views that a creditor may voluntarily agree to release its claim against third parties"); *see generally, The S.E.C. Speaks in 1995*, 9 INSIGHTS 25 (1995).

[1348] *See* Howard C. Buschman III & Sean P. Madden, *The Power and Propriety of Bankruptcy Court Intervention in Actions between Nondebtors*, 47 BUS. LAW. 913 (1992) (bankruptcy court does not have jurisdiction over nondebtors in absence of significant bankruptcy-related effect on estate).

[1349] *See, e.g., In re* Master Mortgage Inv. Fund, Inc., 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (providing overview of factors that courts have considered in permitting third party releases);

legitimate reasons to permit a plan proponent to solicit releases, as such releases will benefit the bankruptcy estate and will be necessary for an effective reorganization. Courts can assess the fairness of the use of additional consideration from the debtor or a third party to encourage release of nondebtor claims. Once approved, these nondebtor releases should be enforceable by courts.

This Proposal does not specifically address injunctions relating to mass future claims that channel such obligations away from the debtor, but that also could be used to channel obligations away from nondebtors. However, if claimants released their claims against a debtor's insurer in exchange for the contribution of insurance proceeds into a trust, those proceeds could be directed toward a particular fund through a channeling injunction, and demands of certain claimants likewise could be channeled to that fund for compensation under this proposal.

The Commission did not consider the application of nondebtor releases in the context of contractual subordination where a senior class votes not to enforce rights against subordinated debt.[1350]

Claims against nondebtor parties in the partnership context are addressed specifically in the section on partnerships and partners in this report.

Competing Considerations. Some might argue that the Proposal is too narrow because the majority of a class should be able to bind the minority on all issues, including the release of nondebtor parties from certain liabilities. Absent majority rule on releases, a dissenting minority in any class could exercise undue leverage and derail a plan of reorganization notwithstanding majority support for release. Although economic considerations would lead to the conclusion that the majority should be able to bind the minority when release would be essential to the success of the reorganization, this more permissive approach may impose insufficient checks on self-dealing. Requiring dissenting or nonvoting creditors to release nondebtors may be insufficiently protective of creditors' rights.

It also might be argued that courts should continue to have flexibility in dealing with the issue of third party releases and that legislation limiting the ability of courts to do so is premature.

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see also In re Swallen's, Inc., 210 B.R. 123 (Bankr. S.D. Ohio 1997) (denying settlement between unsecured creditors' committee and debtor releasing nondebtors for failure to meet Master Mortgage factors).

[1350] *See* 11 U.S.C. § 510(a) (1994).

Others have concluded that releasing nondebtor parties might be an inappropriate use of the bankruptcy mechanism.[1351] According to this view, any third party releases in bankruptcy would extend bankruptcy court intervention well beyond the confines of a bankruptcy case, using bankruptcy for contract negotiation.

2.4.14 *Exclusion of Payroll Deductions from Property of the Estate*

Congress should amend 11 U.S.C. § 541(b) to clarify that funds deducted from paid wages within 180 days prior to the date of the commencement of a case under title 11, held by a debtor/employer, and owed by employees to third parties, other than a federal, state or local taxing authority, do not fall within the definition of "property of the estate."

The filing of a bankruptcy petition creates an estate that is comprised of all legal or equitable interests of the debtor as delineated in 11 U.S.C. § 541(a). The bankruptcy estate includes funds held in a debtor's bank accounts, but the bankruptcy estate is not supposed to include property actually held in trust for another party.[1352]

Payroll deduction is a standard means for employees to make payments to third parties.[1353] A portion of employee wages is withheld from their paychecks and periodically transferred to the appropriate third parties. Businesses frequently hold funds deducted from their employees' paychecks awaiting periodic transfer to third parties.

[1351] *See* Union Carbide Corp. v. Newboles, 686 F.2d 593, 595 (7th Cir. 1982) (under Bankruptcy Act of 1898, "extra-bankruptcy significance" cannot be accorded to creditor's vote; "mechanics of administering the federal bankruptcy laws, no matter how suggestive, do not operate as a private contract to relieve co-debtors of the bankrupt of their liabilities"). The Seventh Circuit abrogated this finding in Union Carbide in *In re* Specialty Equip. Co., Inc., 3 F.3d 1043, 1047 (7th Cir.1993) (court can uphold and enforce consensual releases of nondebtor parties). *See also* Underhill v. Royal, 729 F.2d 1426 (9th Cir. 1985).

[1352] *See, e.g.,* Begier v. Internal Revenue Service, 496 U.S. 53 (1990) (prepetition payment of trust fund taxes to IRS from general accounts was not transfer of property of estate); City of Farrell v. Sharon Steel Corp., 41 F.3d 92, 101 (3d Cir. 1994) (citing legislative history indicating that courts could use "reasonable assumptions" in segregating trust fund monies from general account funds, and finding that this statement was not limited to statutory trusts of IRS).

[1353] A nonexhaustive list of the kinds of payments routinely made through payroll deductions would include: 401(k) and other retirement and savings program contributions, health insurance premiums (including supplemental benefits such as optical and dental coverage), flexible spending account contributions for dependent care and medical expenses, credit union and other loan repayments, membership or agency union dues, child support and other wage garnishment obligations, and charitable contributions.

Such payroll deductions are used to administer many valuable and popular benefit programs. In voluntary programs, credit union loans or other loans might be repaid through payroll deductions for the convenience of both the employee and the lender. The employer is merely a conduit between its employee and the lender in that case. Other programs are employer-sponsored, under which both the employer and the employee make contributions to a pension fund.[1354] Union dues are paid by the employee through payroll deductions under applicable laws. Court-ordered support obligations may have to be paid through payroll deductions, as do other payments made through wage garnishments.

Rather than holding these funds in segregated accounts, employers with cashflow problems commonly hold the funds in the interim period in general operating accounts intermingled with unencumbered funds. Thus, when an employer has not transferred its employees' funds to the appropriate third parties before it files for bankruptcy, those funds are caught in the debtor's general accounts, which are property of the debtor's estate. Without clear statutory guidance to the contrary, the funds become "trapped" in the bankruptcy estate. The current laws do not provide adequate options for employees to remedy this situation.

Meanwhile, the employer's failure to remit these payments to third parties can create serious financial problems for employees. They may be forced into default on these obligations, which might hurt their credit ratings. Employees involuntarily jeopardize their insurance coverage. The employees may end up remiss on their child support obligations.

For employees who are able to make duplicate payments to third parties to avoid default on their obligations, pursuing reimbursement on the duplicated payment through the bankruptcy claims process may yield only a small percentage when the bankruptcy payouts ultimately are made. Bankruptcy policy does not favor the allocation of disproportionate losses to involuntary, nonadjusting creditors, such as employees, who cannot spread these losses over time. Employees may not even have known that they entered a debtor-creditor and/or trust relationship when they agreed to have funds withheld from their paychecks. In some instances, the third party who is not being paid is also a nonadjusting party; when domestic support obligations of an employee are not forwarded to an ex-spouse or child, there may be acute consequences.

Current law has been inadequate to resolve this issue in a fair and cost-effective manner. The trapped funds sometimes are freed through court orders issued on the first day of a bankruptcy case (known as "first day orders") that authorize the

[1354] With respect to employer-sponsored benefit plans or employer-matched charitable contributions, this Proposal deals only with the *employee's* contribution, and does not address the monies owed by the employer.

payment of prepetition wages. However, these orders may release only those payments owed directly to the employee and not to third-party transferees. In addition, courts vary greatly in their latitude regarding the use of first day orders. Other efforts by employees in the bankruptcy process to free the funds and have them paid to third party transferees have not always been successful. When determining whether the trapped funds should be forwarded to third parties, courts may refuse to do so if the employees cannot prove the existence of an express trust, a difficult task when the funds are not kept in a segregated account and cannot be traced sufficiently to satisfy the strict requirements of trust law.[1355] Some laws, such as ERISA, deem employee contributions to be held in trust, and therefore ERISA plan contributions are more likely to be recoverable,[1356] but the inability to trace funds can be fatal to the collection of non-ERISA benefit plans and third-party payments. Furthermore, attempts to establish a "constructive trust," a fiction retroactively applied as a remedy to deal with fraud, have been met with questionable success since these cases generally do not involve an allegation of intentional wrongdoing on the part of the employer.[1357]

The Commission recommends a statutory amendment that would make clear that these withheld funds are not property of the estate. This Recommendation is consistent with both bankruptcy and nonbankruptcy policy. The policies and purpose behind the creation of a broad bankruptcy estate would not be undermined by an amendment that reinforces the basic tenets of what properly belongs in the debtor's estate. The recommended clarification is consistent with other social policies favoring savings plans, insurance, and the payment of domestic support obligations.

[1355] *Id.* at 412; *In re* Columbia Packing Co., 35 B.R. 447, 448 (Bankr. D. Mass. 1983) (employees unable to direct debtor to remit withheld funds to third party transferees because "general cash account is property of the estate. No separate trust fund was created for these employee payroll deductions").

[1356] *See In re* College Bound, Inc., 172 B.R. 399 (Bankr. S.D. Fla. 1994) (tracing requirement does not apply because funds are deemed to be assets of ERISA plan under express statutory trust).

[1357] *See In re* Lee Way Holding Co., 113 B.R. 410 (Bankr. S.D. Ohio, 1990) (avoiding postpetition transfer of union dues to union owed from prepetition wage deduction). "A constructive trust is the formula through which the conscience of equity finds expression. When property has been acquired in such circumstances that the holder of legal title may not in good conscience retain the beneficial interest equity converts him into a trustee." Beatty v. Guggenheim Exploration Co., 122 N.E. 378, 386 (N.Y. 1919). *See generally* Jeffrey Davis, *Equitable Liens and Constructive Trusts in Bankruptcy: Judicial Values and the Limits of Bankruptcy Distribution Policy*, 41 FLA. L. REV. 1 (1989); Thomas H. Jackson, *Statutory Liens and Constructive Trusts in Bankruptcy: Undoing the Confusion*, 61 AM. BANKR. L. J. 287 (1987) (constructive trusts should be recognized to extent they would be recognized under state law). *But see* XL Datacomp, Inc. v. Wilson (*In re* Omegas Group, Inc.), 16 F.3d 1443, 1452 (6th Cir. 1994) ("constructive trusts are anathema to the equities of bankruptcy").

Maximizing the safety of the wage deduction mechanism for insurance payments and retirement fund payments is in everyone's best interest.

In addition to furthering bankruptcy and nonbankruptcy policy, this Proposal also has an important jurisprudential effect because it would inhibit the continuing relaxation of the constructive trust standards as they are applied in the bankruptcy context. In general, constructive trusts offer a remedy that is best used sparingly, if at all, in the very limited set of cases involving fraud to return property to wronged parties. When parties successfully convince a court to expand the application of the constructive trust doctrine when the doctrine should not apply, whether in the context of a first day order or otherwise, the outcome may seem socially defensible but has troubling implications in other contexts.[1358] When courts then adopt a flexible interpretation of what creates a constructive trust, the concept of property of the estate unravels, as does the concept of equality of treatment among creditors.[1359] An open-ended application of the constructive trust doctrine ultimately undercuts the collection of estate assets for equitable distribution to all creditors. Codifying the wage deduction exclusion will enable courts to accomplish desirable ends without stretching the law in ways that will have negative repercussions in other situations.

The Recommendation affects deductions only from wages that actually have been paid in the debtor's records. The goal is to obtain equality among employees so that those employees who used their employer to hold wages for third party payments are similarly situated to those who make all payments directly to their creditors. The clarification would not enable an employee or her creditor to obtain a priority repayment of a portion of her wages if the employer has suspended all wage payments. The Proposal merely would establish that the withheld funds, once wages were paid, are not property of the estate at all. If the otherwise unencumbered cash balance in the debtor's account is insufficient to cover the entire amount of the trapped funds, any shortage would be entitled to priority claim status under sections 507(a)(3) or (a)(4) to the extent permitted by those priorities.[1360]

This Proposal does not affect an employer's independent obligation to contribute to employee benefit funds or on a claim arising from nonpayment of that obligation. Those are direct responsibilities of the employer/debtor and do not

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[1358] For example, the Court of Appeals for the Third Circuit has advocated that section 541(d) excludes not only the property of express trusts but also property subject to constructive trusts. *In re* Columbia Gas, 997 F.2d 1039, 1059 (3d Cir. 1993).

[1359] *See In re* DeLauro, 207 B.R. 412 (Bankr. D.N.J. 1997) (imposition of constructive trust is necessary to prevent unjust enrichment).

[1360] 11 U.S.C. § 507(a)(3), (4) (1994) (giving priority in distribution to wage claims and contributions to employee benefit plans).

implicate the employee. Nor does this section affect the application of sections 547 or 548 to unwind questionable transfers of the debtor company's funds.

Competing Considerations. One might argue that the suggested provision is special interest legislation that would further complicate the interpretation and application of section 541. However, this Proposal is consistent with the notion of property of the estate and exclusions thereof.

III. The Plan Confirmation Process

The process of developing and confirming a plan begins with an evolving series of negotiations. A plan of reorganization must comply with several statutory requirements dispersed throughout Chapter 11. In addition to the formal requirements, however, the plan proponent must gain the support of the creditors because usually their votes will determine the likelihood of confirming a plan, the terms of the deal, and the ownership and management of the business.

The Chapter 11 plan confirmation rules set the basic leverage points for the parties in their negotiations to reorganize a failing business, in or out of court. When the statute is unclear on a point of law and the courts have not agreed on a single interpretation, parties are unsure about their legal rights. As a result, each side faces the possibility that through litigation it can get more than the other side is willing to concede. Even a party that is relatively certain of losing a dispute in court may be able to exploit statutory ambiguities: if parties see that they can threaten to litigate, with the attendant delay and cost that it would impose on other parties, they can press for a higher settlement than they might otherwise have received. To reduce the leverage that comes from litigation threats and to encourage the parties to move toward speedy reorganizations or liquidations, the Commission's proposals dealing with plan confirmation are focused principally on issues in substantial conflict. In addition, the Commission recommends additions to the Bankruptcy Code to facilitate the use of prepackaged plans of reorganization to encourage the parties to find the quickest, least expensive form of reorganization for viable businesses.

2.4.15 *Absolute Priority and Exclusivity*

11 U.S.C. § 1129(b)(2)(B)(ii) should be amended to provide that the court may find a plan to be fair and equitable that provides for members of a junior class of claims or interests to purchase new interests in the reorganized debtor.

11 U.S.C. § 1121 should be amended to provide that on the request of a party in interest, the court will terminate exclusivity if a debtor moves to confirm a non-consensual plan that provides for the participation of a holder of a junior claim or interest under 1129(b)(2)(B) but does not satisfy the condition set forth in section 1129(b)(2)(B)(i).[1361]

[1361] FED. R. BANKR. P. 3016(a) (1997), which governs the time for filing a plan in a Chapter 11 case, would have to be amended to reflect the proposed modification.

Most Chapter 11 plans that are confirmed are consensual plans.[1362] This means that classes of claims are unimpaired by the plan or, if classes of claims are impaired, one half in number and two thirds in dollar amount of those claimants who actually vote have accepted the plan.[1363] If a debtor can obtain favorable votes from creditors holding the requisite majorities in classes of claims on a plan that satisfies all applicable statutory requirements, the debtor can confirm a consensual plan. A fundamental component of Chapter 11 is the ability to confirm a "cramdown" plan of reorganization over objections of some classes of claims if the plan proponent provides fair and equitable treatment to such classes and does not discriminate against them.[1364] The availability of cramdown is an essential part of the reorganization process because it limits the ability of a creditor to hold out for better treatment. It also permits viable businesses to reorganize even over the strenuous objections of a few creditors.

Yet, because confirming a plan under these conditions sometimes involves difficult and extensive judicial valuation, debtors have a strong interest in reaching consensus with the majority of each class of claim holders.[1365] In their negotiations, debtors and some creditors will do what they can to gain the support of creditors and equity holders to minimize the costs to the debtor of Chapter 11 in the form of administrative expenses and loss of public confidence. The rules governing cramdown of a plan set the ultimate parameters for all plan negotiations.

[1362] *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) (observing nearly universal agreement among interviewees that consensual plans were highly desirable and contested cram down hearings were to be avoided); Jonathan M. Landers & Kathryn A. Coleman, *Unexpected Allies: The Bankruptcy Judge and Debtor's Counsel*, 112 BANKR. L. J. 997 (1995) (anecdotal evidence indicates that vast majority of plans are consensual even though there may be significant disputes during process); Richard F. Broude, *Cramdown and Chapter 11 of the Bankruptcy Code: The Settlement Imperative*, 39 BUS. LAW. 441 (1984) (noting paucity of cramdown cases because of incentives for settlement in Bankruptcy Code).

[1363] *See* 11 U.S.C. § 1126(c) (1994) (for a class of claims to have accepted a plan, requiring at least two-thirds in amount and more than one half in number vote in favor of the plan).

[1364] *See* 11 U.S.C. § 1129(b) (1994).

[1365] J. TROST, G. TREISTER, L. FORMAN, K. KLEE, & R. LEVIN, RESOURCE MATERIALS: THE NEW FEDERAL BANKRUPTCY CODE 335-39 (1979) (section 1129(b) valuation will be sufficiently time-consuming "to stimulate senior classes to permit juniors to receive a portion of going concern bonus in return for elimination of a full valuation hearing"). *See also* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. PA. L. REV. 125, 133 (1990) (Congress intended to promote settlements that did not comport with absolute priority rule to protect equity holders from domination by powerful creditors).

Because the rules of cramdown have implications for all plan negotiations, it is important that these rules be balanced, fair, and, above all, clear. Any legal uncertainty regarding the rules of cramdown creates a turbulent environment for negotiating the reorganization of businesses. The Bankruptcy Reform Act of 1978 limited the holdout power of a single creditor or small group of creditors. However, a creditor that otherwise would agree with a plan still retains significant power to obtain more value if holding out can sink the entire reorganization effort. The ability to hold out continues to play a significant role in negotiations depending on the legal parameters of the cramdown power. The size and complexity of the reorganization of a large or publicly held debtor make it particularly desirable to avoid cramdown litigation. The potential adverse impact of imposing the cramdown powers is so significant that plan proponents generally are eager to negotiate consensual settlements in large cases. In small family-run businesses, the impact of cramdown rules is somewhat different. The debtor and creditors are often at the mercy of one or two very powerful creditors, but cramdown rules can work to hold the interests of that small group of powerful creditors in check. However, litigation over ambiguous cramdown rules can foreclose any possibility of reorganizing a family farm or a "mom-and-pop" store because they cannot afford the extensive litigation that would be required. Cramdown rules also protect creditors from overreaching by debtors, making certain that a debtor cannot confirm a plan that treats creditors unfairly. For these reasons, fair and clear cramdown rules are necessary to maximize the likelihood that an appropriate opportunity for reorganization is available to the parties.

A primary component of determining whether a cramdown plan is fair and equitable to objecting creditors is the "absolute priority rule."[1366] The absolute priority rule fixes the distribution order of the parties at the time the case is filed. The term "absolute priority" recognizes that creditors have an absolute right to be provided for in full ahead of the equity owners of a business. According to this rule, if the plan would not provide for objecting superior classes (*e.g.*, unsecured creditors) in full, a court will not confirm a nonconsensual plan that provides for any distribution to a lower priority class (*e.g.*, equity) or allows that class to retain property "on account of" its prior interest. This rule originally was applied in the context of 19th Century railroad reorganizations to prevent senior creditors and equity holders from colluding to squeeze out junior creditors.[1367] In contemporary Chapter 7 cases, this

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[1366] 11 U.S.C. § 1129(b)(2)(B) (1994) ("fair and equitable" plan must fully satisfy claims of senior classes of unsecured creditors before junior classes receive or retain any property on account of their prior ownership interests).

[1367] Northern Pac. Ry. v. Boyd, 228 U.S. 482, (1913). *See also* Corestates Bank, N.A. v. United Chem. Techs., Inc. 202 B.R. 33 (E.D. Pa. 1996), *citing In re* Albrechts Ohio Inns, Inc., 152 B.R. 496, 501 (Bankr. S.D. Ohio 1993) (origins of absolute priority rule lay in efforts to frustrate collusive arrangements between secured creditors and equity holders at expense of unsecured creditors); *In re* Tallahassee Assocs. L.P., 132 B.R. 712, 715 (Bankr. W.D. Pa.1991) (rule originated with equity jurisdiction of court, promulgated by Supreme Court when questions arose concerning rule finds expression in the priority provisions of the Bankruptcy Code that leave distribution to equity for last, after all debt has been paid.

In today's Chapter 11 cases, the absolute priority rule is not quite "absolute," for senior classes can agree to give up value to junior classes in a consensual plan, so long as the plan meets the best interest of creditors test.[1368] However, prepetition equity holders have no right to participate in a plan of reorganization over the objections of unsatisfied, or partially unsatisfied, classes of senior creditors. Yet, Chapter 11 reorganizations often go forward with new equity investment, which in some cases is furnished by equity holders in the prebankruptcy business.

The question that inevitably arises, therefore, is whether the absolute priority rule prevents these prepetition equity holders from participating in the reorganization over the objections of senior dissenting classes if former equity holders infuse substantial *new* capital and thus purchase interests in the reorganized debtor. This participation based on additional contributions to the business is known as the "new value exception," or "new value corollary,"[1369] to the absolute priority rule. The new

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precedence of creditors over shareholders in reorganization cases).

[1368] The absolute priority rule is statutorily mandated only for the confirmation of a nonconsensual case. Empirical studies show that publicly-held debtors and their creditors routinely negotiate for plans that would not satisfy the absolute priority rule, although equity holders may not get more than nuisance value in insolvent cases. Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 611 (1993); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990) (in review of 37 publicly held companies, strict priority of claims was violated in 29 cases); Allan C. Eberhart, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990); (of 24 publicly held corporations in bankruptcy with creditor deficit, shareholders in 23 of cases received payments in violation of absolute priority rule); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. Firms in Reorganization*, 44 J. FIN. 747 (1989) (payments to shareholders in excess of what they would receive under absolute priority rule is essentially purchases by creditors of shareholders' option to delay reorganization and impose future legal and administration costs on creditors).

[1369] Because nothing in the statute prevents anyone from receiving a share in the reorganized business in return for a new investment of capital, some argue that the new value doctrine is an inherent corollary to the absolute priority rule, not an exception. *See, e.g., In re* SM 104 Ltd., 160 B.R. 202 (Bankr. S.D. Fla. 1993), citing Elizabeth Warren, *A Theory of Absolute Priority*, 1990 ANN. SURV. AM. L. 9; Bruce A. Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991) (new value is rough formulation of absolute priority); Anthony L. Miscioscia, Jr., *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need for Competitive Bidding*, 79 VA. L. REV. 917 (1993); Randolph J. Haines, The True Paternity of Bonner Mall: Equivalent New Value Was Never an Exception 6-47, 68th Ann. Meeting of Nat'l Conf. Bankr. Judges (Oct. 6-9, 1994); *In re* Bonner Mall Partnership, 2 F.3d 899, 906 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681, *motion to vacate denied and dismissed as moot*, 513 U.S. 18 (1994); *In re* Montgomery Court Apartments of Ingham County, Ltd., 141 B.R. 324, 343, 345 (Bankr. S.D. Ohio 1992) (true new value contribution "simply does not value exception was a reasonably well-established principle in Chapter X of the Bankruptcy Act of 1898, which required full creditor acceptance and court approval of the plan as being "fair and equitable."[1370] However, the absolute priority rule and new value exception applied in all Chapter X cases but were thought to be unnecessary in Chapter XI cases.[1371]

The Bankruptcy Code of 1978 did not impose an absolute priority rule in consensual plans or for sales. Parties were free to bargain for plans, even with minority dissenting votes, that could be adopted and implemented without the need for courts to determine that the plans were "fair and equitable." Instead, Congress codified the "fair and equitable" requirement and the absolute priority rule for nonconsensual plans, but without any explicit authorization—or prohibition—of the new value exception. Because the concept of a new value exception is not expressly codified in the Bankruptcy Code and must be gleaned from the doctrine of case law, the mere mention of "new value" inevitably sets off an analysis of semantics, history,

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violate absolute priority rule"); *In re* Creekside Landing, Ltd., 140 B.R. 713, 717 (Bankr. M.D. Tenn. 1992); *In re* Woodscape Ltd. Partnership, 134 B.R. 165 (Bankr. D. Md. 1991); *See also In re* Trevarrow Lanes, Inc., 183 B.R. 475, 493 (Bankr. E.D. Mich. 1995) ("Los Angeles Lumber was neither rejected nor blessed by Congress: rather, the Code leaves it to the courts to decide whether the "fair and equitable" objective is subserved by the Los Angeles Lumber condition that the contribution be essential, just as would be true with respect to any other requirements not specifically set forth in § 1129(b)(2)"). The phrase "exception" has nonetheless become part of the lexicon in referring to equity's post-filing participation in a case.

[1370] To be confirmed under Chapter X and its predecessor, section 77B, of the 1898 Bankruptcy Act, all plans had to be subjected to court determination that they were "fair and equitable" to creditors. 11 U.S.C. § 621(2) (repealed 1979). Plans required the support of all creditors, not just the majority of each class of creditors. According to the United States Supreme Court in *Northern Pacific Railway Co. v. Boyd*, a "fair and equitable" plan reflected the priority of creditors and equity holders in accordance with contract principles, thus preferring stockholders to creditors was invalid. Northern Pac. Ry. v. Boyd, 228 U.S. 482, 504 (1913) (striking down railroad reorganization plan); Louisville Trust Co. v. Louisville, New Albany & Chicago Ry. Co., 174 U.S. 674, 684 (1899) (arrangement securing subordinate rights and interests of stockholders at expense of prior rights of classes of creditors warrants "judicial denunciation"). Yet, the principle of absolute priority announced in Boyd was not quite absolute: early on, the Supreme Court recognized that in some instances, former stockholders should be able to provide new and essential money for the reorganization of an insolvent company if there are sufficient protections for creditors. Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445, 455 (1926). This was later reaffirmed in *Case v. Los Angeles Lumber*, 308 U.S. 106, 121 (1939), *reh'g denied*, 308 U.S. 106, which is discussed in the following pages.

[1371] The long recognition that owners of small businesses owed their creditors only the liquidation value of the their businesses and could retain the remaining value may be an important consideration in developing an optimal way to deal with the smaller reorganization cases for which Chapter XI was designed. H.R. REP. NO. 95-595, 412 (1977), *reprinted in* COLLIER ON BANKRUPTCY, App. 2, at 222 (Lawrence P. King et al. eds., 15th ed. 1996).

and statutory interpretation.[1372] The doctrine has generated a substantial body of scholarly commentary discussing whether the doctrine remains viable.[1373] Courts

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[1372] In the absence of clear guidance in the statute, courts have looked to legislative history but have found it inconclusive. *See, e.g.*, *In re* Bryson Properties, XVIII, 961 F.2d 496 (4th Cir. 1992), *cert. denied*, 506 U.S. 866 (1992); *In re* Woodscape Ltd. Partnership, 134 B.R. 165, 170 (Bankr. D. Md. 1991). In recommendations for legislative change that preceded the Bankruptcy Code, the 1973 Commission Report proposed an explicit corollary to the absolute priority rule that would have allowed courts to consider the value of less tangible and prospective contributions, such as continuity of management. REPORT OF THE COMMISSION ON BANKRUPTCY LAWS, H.R. DOC. NO. 93-137, part I, 258-259 (1973). The National Conference of Bankruptcy Judges made the same suggestion. *See* Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L.J. 229 (1990), *citing* S. 235, 94th Cong., 1st Sess. 209 (1973) and H.R. 32, 94th Cong., 1st Sess. 223 (1975). The 1978 Code includes neither the 1973 Commission formulation nor the traditional Los Angeles Lumber formulation.

[1373] *See*, e.g., Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L. J. 229 (1990) (validity of new value exception unclear in wake of Ahlers); Kenneth N. Klee, *Timbers, Ahlers & Beyond*, 1989 ANN. SURV. BANKR. L. 1 (Pt. 1); Linda J. Rusch, *The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should The Rule Be?* 19 PEPP. L. REV. 1311 (1992) (status of new value exception is unclear); Sara A. Austin, *New Value Exception: (Wanted) Dead or Alive - Viability of the 'New Value Exception' to the Absolute Priority Rule Under Bankruptcy Code § 1129(b)(2)*, 96 DICK. L. REV. 189 (1992) (viability of new value exception unclear; until Congress or Supreme Court resolves issue, each court will reach different results); Jeffrey M. Sharp, *Bankruptcy Reorganizations, Section 1129 and the New Capital Quagmire: A Call for Congressional Response*, 28 AM. BUS. L.J. 525 (1991) (bankruptcy system is in state of chaos concerning status of new value exception, leading to increased costs and delay tactics, and must be resolved by Congress); Charles R. Sterbach, *Absolute Priority and New Value Exception: A Practitioner's Primer*, 99 Com. L.J. 176 (1994) (status of new value exception uncertain, but lawyers know view of judges in their district); Anthony L. Miscioscia, *The Bankruptcy Code and the New Value Doctrine: An Examination into History, Illusions, and the Need For Competitive Bidding*, 79 VA. L. REV. 917 (1993) (survival of new value exception unclear); Mark E. MacDonald & Sally A. Schreiber, *Confirmation by Cramdown Through the New Value Exception in Single Asset Cases*, 1 AM. BANKR. INST. L. REV. 65 (1993) (uncertain whether new value exception survived); John T. Bailey, *The New Value Exception in Single Asset Reorganization: A Commentary on the Bjolmes Auction Procedure and its Relationship to Chapter 11*, 98 COM. L.J. 50 (1993) (survival of new value exception is not clear); Richard Epling, *The New Value Exception: Is There A Practical, Workable Solution?* 8 BANKR. DEV. J. 335 (1991) (unclear whether new value exception exists); Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 DET. C.L. REV. 1445 (chaos in this area); Wayne Johnson, *In re Bonner Mall Partnership: the Ninth Circuit Embraces the New Value "Exception,"* 21 CAL. BANKR. J. 259 (1993) (foreseeing more chaos over issue); Michelle Craig, *The New Value Exception: A Plea for Modification or Elimination*, 11 BANKR. DEV. J. 781 (1995) (unclear whether new value exception exists); David R. Perlmutter, *Navigating a Proposed New Value Plan Through the Cross-Currents of the Confirmation Process: An Arduous Journey for the Debtor of a Single Asset Case*, 17 WHITTIER L. REV. 427 (1996) (existence of new value exception is unclear, and in meantime, outcome in cases depends on attorneys' skill and creativity); Steven W. Rhodes, *Eight Statutory Causes of Delay and Expense in Chapter 11 Bankruptcy Cases*, 63 AM. BANKR. L.J. 287 (1993). *See generally* Charles W. Adams, *New Capital For Bankruptcy Reorganizations: Its the Amount that Counts*, 89 Nw. U. L. Rev. 411 (1995); David R. Kuney & Timothy R. Epp, *Aftermath of Bonner* expend a tremendous amount of time and effort on the threshold question of the doctrine's survival and its scope before turning to the merits of a case. Even courts that express doubts about the exception's viability do not conclusively hold as such, thus provide little guidance to courts and parties; instead, they undertake the new value analysis to prove that the exception would not apply in any event to the case at bar.

The resulting litigation is expensive and delays progress in the plan negotiation process. Parties squabble over the existence or nonexistence of a rule that is crucial to the basic question of how the equity financing of the business will be structured. Cases that can be confirmed in one jurisdiction have no hope of confirmation in others. This increases forum shopping and heightens the perception that bankruptcy law is more a matter of luck-of-the-draw justice than of consistent application of recognized principles.

When courts recognize the new value exception, the determination of whether a capital contribution satisfies the new value exception in a given case is inherently fact-specific. A United States Supreme Court decision under the Bankruptcy Act of 1898, *Case v. Los Angeles Lumber Products,* delineated some guiding factors.[1374] *Case* has provided the basis for inquiry by those courts that have endorsed the new value principle's continuing viability. While case-specific analysis varies, the factors have remained reasonably constant over time. Courts generally have considered whether the contribution is:

1) new;
2) substantial;
3) money or money's worth;
4) necessary for a successful reorganization; and
5) reasonably equivalent to the interest obtained.[1375]

Mall: Evolution or Regression in the Notion of "New Value?" 5 J. BANKR. L. & PRAC. 211 (1996).

[1374] Case v. Los Angeles Lumber Prods., 308 U.S. 106, 121 (denying confirmation of plan found not to be fair and equitable because it gave former shareholders 23% of assets and voting power in exchange for shareholders' financial standing, community influence, and continuity of management), *reh'g denied*, 308 U.S. 637 (1939).

[1375] *See* e.g., *In re* Ambanc LaMesa Ltd. Partnership, 115 F.3d 650 (9th Cir. 1997); *In re* Bonner Mall Partnership, 2 F.3d 899, 908 (9th Cir. 1993, *cert. granted*, 114 S.Ct. 681 (1994); *In re* U.S. Truck Co., 800 F.2d 581,588 (6th Cir. 1986); *In re* Woodbrook Assocs., 19 F.3d 312, 320 (7th Cir. 1994) (citing and applying factors but declining to hold affirmatively that new value exception remains vital), *reh'g denied,* 1994 U.S. App. Lexis 10784 (7th Cir. 1994); *In re* Sea Garden Motel and Apts., 195 B.R. 294, 300 (D.N.J. 1996).

Analyzing the "substantiality" and "reasonable equivalence" components of this test depends heavily on legal theories and techniques of valuation. While courts do the best they can to determine the relative equivalence between the capital contribution offered and the value of the resulting equity interest, the variability in judicial determinations of value leaves some observers wary.[1376] Some criticism of the doctrine of new value understandably stems from concern that the valuation of the business will be inaccurate, permitting equity owners to capture value that should have gone to the creditors.

In addition, the fact that former equity holders have an exclusive right to propose a plan leads some to conclude that this exclusive right is "on account of" equity's prior ownership interest in violation of the absolute priority rule.[1377] Section 1121 of the Bankruptcy Code gives the debtor the exclusive right to propose a plan for 120 days, a period that routinely is extended for cause.[1378] Although a court is empowered to terminate the exclusivity period, this relief rarely is granted. Thus, courts sometimes confirm new value plans while the debtor is the only party who is empowered to propose a plan.[1379]

[1376] *See*, e.g., Chaim Fortgang & Thomas Moers Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1125 (1985) (valuation in bankruptcy inherently is prediction or estimate of future rather than mathematical certitude; cramdown confirmation may be most difficult kind of valuation); Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 546 (1983)(bankruptcy court unlikely to make astute independent determination of either the firm's value or impact on firm viability of questionable level of debt). *See* also Jeffrey Stern, Note, *Failed Markets and Failed Solutions: The Unwitting Formulation of the Corporate Reorganization Technique*, 90 COLUM. L. REV. 783, 801 (1990) (failure to utilize market in valuing entity is "inefficient, inaccurate, and encourages litigation"), *citing* Thomas Jackson, *Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain*, 91 YALE L.J. 857 (1982).

[1377] *See, e.g.*, Travelers Ins. Co. v. Bryson Properties, XVIII, 961 F.2d 496 (4th Cir.), *cert. denied*, 506 U.S. 866 (1992); *In re* BMW Group I Ltd., 168 B.R. 731, 735 (Bankr. W.D. Okla. 1994); *In re* Krisch Realty, 174 B.R. 914 (Bankr. W.D. Va. 1994); *In re* Ropt Ltd. Partnership, 152 B.R. 406, 412 (Bankr. D. Mass. 1993); *In re* Bjolmes Realty, 134 B.R. 1000 (Bankr. D. Mass. 1991); *In re* Trevarrow Lanes, Inc., 183 B.R. 475 (Bankr. E.D. Mich.1995)(absolute priority rule violated if others are not offered opportunity to purchase debtor's stock); *accord, In re* Graphic Communications, Inc., 200 B.R. 143 (Bankr. E.D. Mich. 1996).

[1378] "Except as otherwise provided in this section, only the debtor may file a plan until after 120 days after the date of the order for relief under this chapter." 11 U.S.C. § 1121(b) (1994). "On request of a party in interest made within the respective periods specified in subsections (b) and (c) of this section and after notice and a hearing, the court may for cause reduce or increase the 120-day period or the 180-day period referred to in this section." *Id*. § 1121(d).

[1379] *See, e.g., In re* Moonraker Assoc., 200 B.R. 950 (Bankr. N.D. Ga. 1996) (denying motion of request to lift exclusivity), *citing* Bonner Mall Partnership v. U.S. Bancorp Mortgage Co., 2 F.3d 899 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039, *motion to vacate judgment denied and case dismissed*, 513 U.S. 1039 (1994); Penn Mut. Life Ins. Co. v. Woodscape Ltd. Partnership, 134 B.R. 165 (Bankr. D. Md. 1991); *In re* Waterville Valley Town Square Assoc., 208 B.R. 90 (Bankr. N.H.

Due in part to these concerns, not everyone believes that the new value exception does—or should—exist in Chapter 11 of the Bankruptcy Code.[1380] Critics believe that creditors, the residual owners of an insolvent business, should be entitled to determine whether this source of capital should be used to continue the business. If the equity owner could not convince a majority of the creditor classes to vote for a consensual plan, the argument goes, the former equity holders should lose the right to continue participating in the enterprise and the creditors should take over.[1381] Any opportunity for former equity holders to continue participation—even if in exchange for an infusion of additional cash—enhances their leverage against the creditors and should be prohibited.

Supporters of the new value exception might counter that the possibility of receiving new value from former equity holders increases the options for struggling businesses to incorporate fresh contributions of equity capital, and therefore promotes rehabilitation of financially distressed entities.[1382] Barring a business from using an

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1997). "To conclude that a purchase option restrict to old equity is always fatal, in this Court's opinion, is too strict a reading of the requirements of section 1129(b)(2)(B)(ii)." Moonraker, 200 B.R. at 954. *See generally* Charles W. Adams, *New Capital For Bankruptcy Reorganizations: Its the Amount that Counts*, 89 Nw. U. L. Rev. 411 (1995); David R. Kuney & Timothy R. Epp, *Aftermath of Bonner Mall: Evolution or Regression in the Notion of "New Value?"* 5 J. BANKR. L. & PRAC. 211 (1996).

[1380] *See, e.g.,* James J. White, *Absolute Priority and New Value,* 8 COOLEY L. REV. 1 (1991) (no efficiency or moral argument to support existence of new value exception); John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989); David A. Skeel, *The Uncertain State of An Unstated Rule: Bankruptcy's Contribution Rule After Ahlers*, 63 AM. BANKR. L.J. 221 (1989) (new value exception should not be recognized; contribution rule creates incentives for undesirable behavior); M.A. Garcia-Linares, *Phoenix Mutual Life Insurance Co v. Greystone III Joint Venture: An Uncertain Fate for the New Value Exception to the Absolute Priority Rule*, 67 TUL. L. REV. 312 (1992) (new value exception is judicially created loophole and is obsolete under Bankruptcy Code); Lawrence B. Gutcho, *Real Estate Lenders and the Battle over "New Value,"* 110 BANKING L.J. 423 (1993) (new value exception does not exist); Raymond T. Nimmer, *Negotiated Bankruptcy Reorganization Plans: Absolute Priority and New Value Contributions,* 36 EMORY L.J. 1009 (1987) (no reason to protect shareholders' right to retain ownership interest in public company over dissent of senior classes); Julie L. Friedberg, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*, 66 TEMP. L. REV. 893 (1993) (new value exception did not survive enactment of 1978 Code).

[1381] This position relies to some extent on legislative history. Under Chapter X, there was no ability to waive application of the absolute priority rule. However, Chapter 11 of the Bankruptcy Code permits classes to "waive" application of the absolute priority rule by class vote, and thus arguably need not provide a new value exception in a nonconsensual plan. *See In re* 203 N. LaSalle Partnership, Nos. 96-2137 & 96-2138, slip op., at 42 (7th Cir. Sept. 29, 1997) (Kanne, J. dissenting).

[1382] *See, e.g.,* Kenneth N. Klee, *Timbers, Ahlers & Beyond*, 1989 ANN. SURV. BANKR. L. 1 (Pt.1); Linda J. Rusch, *The New Value Exception to the Absolute Priority Rule in Chapter 11 Reorganizations: What Should the Rule Be?* 19 PEPP. L. REV. 1311 (1992) (new value is necessary equity contribution in a reorganization effort can have a significant impact on whether anyone—debtor or creditor—preserves and captures going concern value. The job preservation function of Chapter 11 also is enhanced by giving all comers, including old equity, an opportunity to invest in a failing business to help it reorganize.[1383] Investment dollars are not always readily available for businesses in Chapter 11, particularly for the smaller businesses that have restricted access to capital markets. For small and family-owned businesses, the only access to needed capital may be through the old equity owners. They know more about the business, and they often are willing to pay more than others to help the business survive.

The Commission recommends that the statute explicitly recognize the new value corollary to the absolute priority rule. The Commission believes that it would be economically irrational to foreclose beneficial equity participation that often can provide a valuable source of capital to help fund a business reorganization. Significant benefits can be derived from new value contributions. In smaller cases, the potential to participate in a reorganization can operate as an incentive for certain key managers who are also shareholders to stay with the debtor during what is likely to be the debtor's most difficult time. It may also induce former managers to come up with fresh money sufficient to adequately capitalize the reorganized debtor. In larger cases, negotiating in the backdrop of the new value exception might prevent debtors from negotiating for plans that leave them overleveraged and undercapitalized, a sure recipe for plan failure.[1384]

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tool to negotiate consensual plan); Mark E. MacDonald and Sally A. Schreiber, *Confirmation by Cramdown Through the New Value Exception in Single Asset Cases*, 1 AM. BANKR. INST. L. REV. 65 (1993) (allowance of new value fosters good policy by promoting reorganization); Richard Epling, *The New Value Exception: Is There a Practical, Workable Solution?* 8 BANKR. DEV. J. 335 (1991); Ralph A. Peeples, *Staying In: Chapter 11, Close Corporations and the Absolute Priority Rule*, 63 AM. BANKR. L.J. 65 (1989). *See also In re* Elmwood Dev. Co., 182 B.R. 845, 852 (D. Nevada 1995), *citing* NLRB v. Bildisco & Bildisco, 465 U.S. 513 (1984); Coones v. Mutual Life Insurance of New York, 168 B.R. 247 (D. Wyo. 1994), *aff'd*, 56 F.3d 77 (10th Cir. 1995), *citing In re* Johnson, 101 B.R. 307 (Bankr. M.D. Fla. 1989).

[1383] "It makes no sense to suggest that the creditor body can sell the equity in the reorganized debtor to anyone except the debtor's pre-petition equity holders. Such a blanket rule would, in fact, doom many confirmable Chapter 11 plans, since, as a practical matter, the debtor's pre-petition equity holders may be the only persons who have any interest in buying the equity." *In re* SM 104 Ltd., 160 B.R. 202, 225 (Bankr. S.D. Fla. 1993), *citing* Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURV. AM. L. 9. "The fact that former partners may be among the successful bidders is as irrelevant as the fact that former creditors may be among the successful bidders." *In re* Overland Park Merchandise Mart Partnership, Ltd., 167 B.R. 647, 662 (Bankr. D. Kan. 1994) (denying confirmation on other grounds).

[1384] *See* Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large Publicly Held Companies*, 139 U. PA. L. REV. 125 (1990) (frequent reason for postconsummation failure is that businesses are overleveraged as compared with industry standards).

Concerns about valuation and exclusive bidding rights are legitimate, but need not lead to an unduly restrictive rule that may force some otherwise viable businesses into liquidation. Instead, the Commission also recommends a significant additional condition: exclusivity should be lifted as of right whenever a debtor seeks to confirm a cramdown plan under section 1129(b)(2)(B)(ii) that uses equity contributions from former equity holders in its financing. Not only would the debtor need to satisfy the *Case v. Los Angeles Lumber Products* requirements currently used by courts to determine whether prepetition equity holders have offered necessary and sufficient new value in exchange for their interests, but unsecured creditor cramdown plans would be exposed to the marketplace to satisfy concerns about undervaluation and the value of exclusivity.[1385] The best way to accomplish this marketplace validation of value is to permit other parties to propose plans of reorganization that may garner creditor support to compete when the debtor moves for confirmation of an unsecured creditor cramdown plan. The Proposal is designed to maintain the balance between the need for capital to preserve the business and its going concern value and the need to increase the certainty that old equity pays a market price for whatever ownership it buys in the reorganized company. Old equity would be treated like any other investor and the process would welcome the capital needed to reorganize, so long as any purchaser had the same opportunity to propose an alternative plan.

The notion that a termination of exclusivity might accompany a debtor's move to cram down a plan is not completely foreign.[1386] Courts already are permitted to shorten the exclusivity periods for cause and even in the absence of a specific provision, several courts have suggested that the Proposal of a new value plan might constitute such cause.[1387] A mandatory exclusivity termination provision will

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[1385] *See* Richard L. Epling, *The New Value Exception: Is There a Practical Workable Solution?* 8 BANKR. DEV. J. 335 (1991); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L. J. 229, 232 (1990). Bruce A. Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 72, 73 (1991) (auction theory and reorganization practice both demonstrate that presence of competitive bidders increases creditor dividends, and former owner involvement evidences confidence that debtor has positive value); Edward S. Adams, *Toward A New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 DET. C.L. REV. 1445, 1486 (proper valuation benefits from third party bids to compete with debtor's bids, thus debtor's right to exclusivity should be eliminated in context of cramdown plans).

[1386] "[I]f a confirmable plan may be reached only through the termination of the exclusivity period, such a measure should find ample justification in the policy as well as the test of the Bankruptcy Code." *In re* Homestead Partners, Ltd.,197 B.R. 706, 714 (Bankr. N.D. Ga. 1996), *citing* United Sav. Ass'n v. Timbers of Inwood Forest Assocs. Ltd., 484 U.S. 365 (1988) (remaining citations omitted). *See also* Richard L. Epling, *The New Value Exception: Is there a Practical Workable Solution?* 8 BANKR. DEV. J. 335 (1991) (Code should clarify that plan can include new value contribution from old equity if debt, equity, and third parties have subscription rights).

[1387] *See* 11 U.S.C. § 1121(c) (1994); *see also* *In re* Homestead Partners, Ltd.,197 B.R. 706

substantially restrict a debtor's opportunity to shield itself from creditors who place different valuations on the reorganized business.

Practically speaking, when a debtor sought confirmation, the confirmation process would stop to give any party eligible under section 1121 an opportunity to propose its own plan. The proposing party would have sufficient time to negotiate, solicit votes, and craft a competing plan. Through this mechanism, any party in interest who believed that the value of the enterprise was higher than the equity holders' assessment would have the opportunity to challenge the valuation in the most concrete way: the party could seek outside financiers or put up its own money to buy the equity stake in the business. Yet, because exclusivity on this basis would not be terminated until the debtor affirmatively sought confirmation of a new value unsecured creditors'cramdown plan, this Proposal would not curtail the opportunity or lessen the incentives of the parties to bargain for a consensual plan.[1388] During the period of exclusivity, a debtor could propose a new value plan to see if it would be sufficiently attractive to the creditors to pass consensually. If it could not muster sufficient support for such a plan, the debtor would have several choices: it could attempt to put together a different consensual plan, it could modify the plan so that it did not involve the new value exception and cram down the modified plan, or it could move for cramdown on the new value plan and forfeit the exclusive right to propose the terms of ownership. Under the latter scenario, parties in interest who believed that equity was seizing value would be free to propose competing plans. In all cases, the parties would have every incentive to continue to try to develop a consensual plan. For this reason, the Proposal would not require termination of exclusivity in specific cases when a debtor *proposed* a new value plan because that timing would not provide ample opportunity to solicit creditor votes and confirm a consensual plan. Only if the unsecured creditors voted "no" and the debtor sought to cramdown under section 1129(b)(2)(B)(ii) would the termination requirement apply.

Because prepetition equity holders would not have an exclusive right to bid on the equity in the reorganized debtor, this Proposal should alleviate the concerns of those who believe retention of a preemptive right to bid for the equity of the reorganized debtor is, itself, property impermissibly retained by the former owners of

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(Bankr. N.D. Ga. 1996); *In re* SM 104 Ltd., 160 B.R. 202 (Bankr. S. D. Fla. 1993). *Accord* Edward S. Adams, *Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception*, 1993 DET. C.L. REV. 1445, 1486.

[1388] Even when exclusivity is lifted, competition does not preclude a consensual plan. When the court in *In re* New Valley Corp., 168 B.R. 82 (Bankr. D.N.J. 1994) declined to extend exclusivity, separate plans were filed by the debtor, secured creditors' committee, unsecured creditors' committee, and equity holders. Equity held out the longest, but parties reached agreement the night before the confirmation hearing and the court confirmed a consensual plan.

the debtor on account of their prior ownership.[1389] At the same time, the bidding process would assist the judge in determining whether prepetition equity holders truly are offering a fresh contribution of assets that is equivalent in value to the interest they expect to receive. The fundamental goal of the Commission's Proposal is to refine the rules to maximize the value of reorganizing enterprises to benefit creditors, employees, shareholders, and the economy at large. Significantly, the process envisioned by this Proposal would offer enhanced protection against undervaluation to creditors as compared to what they currently receive in courts that recognize the new value exception but do not require any exposure to the marketplace.

The Need for Clarification - The Legal Debate. As mentioned earlier, the debates over a new value exception to absolute priority began with the adoption of the new bankruptcy statute in 1978. Many courts presumed that the pre-Code parameters of "fair and equitable," including the new value exception, remained in effect,[1390] evidenced by the fact that two circuit court of appeals decisions, *Potter Material Service*[1391] and *U.S. Truck*,[1392] had affirmed the confirmation of new value plans. This presumption was undermined by the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*, which included a footnote that expressly reserved the question of whether the new value exception survived the enactment of the 1978

[1389] *See*, *e.g.*, Travelers Ins. Co. v. Bryson Properties, XVIII, 961 F.2d 496 (4th Cir.), *cert. denied*, 506 U.S. 866 (1992); *In re* BMW Group I Ltd., 168 B.R. 731, 735 (Bankr. W.D. Okla. 1994); *In re* Krisch Realty, 174 B.R. 914 (Bankr. W.D. Va. 1994); *In re* Ropt Ltd. Partnership, 152 B.R. 406, 412 (Bankr. D. Mass. 1993); *In re* Bjolmes Realty, 134 B.R. 1000 (Bankr. D. Mass. 1991); *In re* Trevarrow Lanes, Inc., 183 B.R. 475 (Bankr. E.D. Mich.1995)(absolute priority rule violated if others are not offered opportunity to purchase debtor's stock); *accord*, *In re* Graphic Communications, Inc., 200 B.R. 143 (Bankr. E.D. Mich. 1996).

[1390] *See*, e.g., Teamsters National Freight Indus. Negotiating Comm. v. U.S. Truck Co., 800 F.2d 581 (6th Cir. 1986); *In re* Potter Material Serv., Inc., 781 F.2d 99 (7th Cir. 1986); *In re* Sawmill Hydraulics, Inc., 72 B.R. 454, 456 (Bankr. C.D. Ill. 1987); *In re* Marston Enters., Inc., 13 B.R. 514, 518 (Bankr. E.D.N.Y. 1981); *In re* Eaton Hose and Fitting Co., 73 B.R. 139 (Bankr. S.D. Ohio 1987); *In re* Roberts Rocky Mountain Equip. Co., 76 B.R. 784 (Bankr. D. Montana 1987); *In re* Landau Boat Co., 13 B.R. 788 (Bankr. W.D. Missouri 1981). *But see In re* Pine Lake Village Apt. Co., 19 B.R. 819 (Bankr. S.D.N.Y. 1982) (equity participation violated absolute priority rule, with no mention of new value exception), *reh'g denied*, 21 B.R. 478 (Bankr. S.D.N.Y. 1982).

[1391] *In re* Potter Material Serv., Inc., 781 F.2d 99 (7th Cir. 1986) (upholding confirmation of new value plan plan for small, closely-held building supplies and materials business in which shareholder offered to infuse approximately $35,000 and renew $600,000 personal guaranty).

[1392] *In re* U.S. Truck Co., 47 B.R. 932 (E.D. Mich. 1985), *aff'd*, 800 F.2d 581 (6th Cir. 1986)(upholding confirmation of plan for automotive parts and supplies shipping business that entailed $100,000 contribution in exchange for 100% ownership).

Code.[1393] Thus, the Supreme Court essentially invited all courts to make an inquiry into whether the new value exception was a viable part of the law.[1394]

The two courts of appeals that have ruled squarely on the issue since *Ahlers* both have held that the doctrine survived. In *Bonner Mall*, the Court of Appeals for the Ninth Circuit held that the new value exception survived enactment of the Code.[1395] The Ninth Circuit reaffirmed this conclusion four years later in *Ambanc La Mesa Limited Partnership*.[1396] In *Bonner Mall*, a creditor sought to lift the automatic stay, arguing that the debtor could not confirm a plan of reorganization because the debtor had no funding options other than an infusion of capital from the old equity owners which, the creditor argued, would violate the rule of absolute priority.[1397] When it ruled that lifting the stay was inappropriate, the Ninth Circuit reviewed the absolute priority rule and its new value exception. The court noted that "the doctrine is not actually an exception to the absolute priority rule but is rather a corollary principle, or, more simply a description of the limitations of the rule itself. It is . . . the set of conditions under which former shareholders may lawfully obtain a priority interest in the reorganized venture."[1398] The court cited with approval the *Case v. Los Angeles Lumber* criteria as developed in pre-Code case law. The Supreme Court

[1393] Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988). The Supreme Court reversed the decision of the Court of Appeals for the Eighth Circuit that upheld confirmation of a plan allowing family farm owners to retain their equity interest in exchange for future contributions of "labor, experience, and expertise" in the farm enterprise. The Supreme Court went only so far as to say that a pledge of future services would not have qualified for the new value exception in any event and stated in a footnote that it was not deciding whether the new value exception survived enactment of the 1978 Code. "[O]ur decision today should not be taken as any comment on the continuing vitality of the Los Angeles Lumber exception . . . . Rather, we simply conclude that even if an ‹infusion-of-money-or money's-worth' exception to the absolute priority rule has survived the enactment of Section 1129(b), respondents' proposed contribution to the reorganization plan is inadequate to gain the benefit of this exception." *Id.* at 203, n.3.

[1394] *See* John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989) (tracing history of and concluding that new value exception was not justified); Kenneth N. Klee, *Cram Down II*, 64 AM. BANKR. L J. 229 (1990) (both courts and academics are split on the survival of the new value exception in light of Ahlers).

[1395] *In re* Bonner Mall Partnership, 2 F.3d 899, 906 (9th Cir. 1993), *cert. granted*, 114 S. Ct. 681 (1994), *motion to vacate denied and dismissed as moot*, 115 S. Ct. 386 (1994).

[1396] *In re* Ambanc La Mesa Ltd. Partnership, 115 F.3d 650 (9th Cir. 1997).

[1397] Bonner Mall, 2 F.3d at 906.

[1398] *Id.* Conversely, had Congress omitted the "on account of" language, this would have indicated intent to prohibit former equity owners from receiving or retaining property in cramdown plans. *See* Dewsnup v. Timm, 502 U.S. 410 (1992) (emphasizing reluctance to overturn pre-Code practice in absence of explicit Congressional instruction).

agreed to review the *Bonner Mall* decision, which would have laid this dispute to rest, but the parties settled the case and therefore the appeal was dismissed as moot.[1399] At the very least, the *Bonner Mall* decision settled the uncertainty among the courts in the Ninth Circuit, where trial courts had issued conflicting rulings on the subject.[1400]

The Court of Appeals for the Seventh Circuit held in *204 N. LaSalle Street Partnership* that the new value corollary is viable, and is the first circuit court to uphold confirmation of an unsecured creditor cramdown new value plan.[1401] The court reasoned that old equity holders making new contributions do not retain interests "on account of" their prior interests in violation of the absolute priority rule.[1402] In discussing policy considerations and legislative choices, the court stated that "the new value corollary has been a major source of funding in reorganizations for the past fifty years," and that Congress would have spoken more explicitly had it intended to change this economic policy.[1403] One judge dissented and opined that the language of section 1129(b) plainly did not provide for a new value exception to the absolute priority rule.[1404] The majority decision further upheld the bankruptcy court's findings that the owners offered a contribution of new capital in money or money's worth that was necessary for the success of the plan and reasonably equivalent to the interest obtained in the reorganized debtor.[1405]

This decision brought an end to a series of decisions issued by the Seventh Circuit that discussed but did not rule on the viability of the new value exception because it would not have been satisfied in any event. Four of these decisions had suggested that the new value exception survived,[1406] while one had taken a contrary

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[1399] 115 S. Ct. 386 (1994).

[1400] *See, e.g.*, *In re* A.V.B.I., Inc., 143 B.R. 738 (Bankr. C.D. Cal. 1992) (exception dead); *In re* F.A.B. Ind., 147 B.R. 763 (C.D. Cal. 1992) (exception lives); *In re* Outlook/Century Ltd., 127 B.R. 650 (Bankr. N.D. Cal. 1991) (exception dead); *In re* Triple R Holdings, L.P., 134 B.R. 382 (Bankr. N.D. Cal. 1991) (exception lives), *rev'd*, 145 B.R. 57 (N.D.Cal. 1992).

[1401] *In re* 203 N. LaSalle St. Partnership, Nos. 96-2137& 96-2138, slip op. (7th Cir. Sept. 29, 1997).

[1402] *Id.* at 17.

[1403] *Id.* at 20.

[1404] *Id.* at 30 (Kanne, J. dissenting).

[1405] *Id*. at 23.

[1406] *In re* Stegall, 865 F.2d 140 (7th Cir. 1989) (family farm case); *In re* Snyder, 967 F.2d 1126, 1129 (7th Cir. 1992) (family farm case); *In re* Woodbrook Assocs., 19 F.3d 312, 320 (7th Cir. 1994) (single asset real estate case); *In re* Wabash Valley Power Ass'n, 72 F.3d 1305 (7th Cir. 1995) view and had exhibited strong skepticism about the viability of the new value exception.[1407]

No circuit other than the Ninth and the Seventh has addressed the issue directly since *Ahlers*. The Court of Appeals for the Eighth Circuit made statements in family farm cases suggesting that it continued to presume that the new value exception was viable.[1408] The Court of Appeals for the Fourth Circuit in *Bryson Properties* expressed concern that new value exception would grant an exclusive bidding right to the debtor, but did not base its decision on this issue.[1409] The Tenth Circuit Court of Appeals also has addressed a new value plan without actually deciding whether the doctrine survives.[1410] The Court of Appeals for the Fifth Circuit

(energy cooperative association case) .

[1407] Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting, 908 F.2d 1351 (7th Cir. 1990) (small business), *reh'g denied en banc,* 1990 U.S. App. Lexis 15618.

[1408] *In re* Blankenmeyer, 861 F.2d 192 (8th Cir. 1988). Family farm owners proposed to retain an interest in their farm without satisfying their mortgagee's deficiency claim in full. The bankruptcy court denied confirmation and the district court affirmed. The Eighth Circuit affirmed and stated that the debtor failed to show that the "junior class contributed something reasonably compensatory and measurable to the reorganization enterprise." *Id.* at 194. The court cited Ahlers only for a basic statement of the fair and equitable requirement. Likewise, in Anderson v. Farm Credit Bank of St. Paul, 913 F.2d 530 (8th Cir. 1990), farm owners proposed a similar plan. The debtor testified that retaining the land was necessary to a successful reorganization and that her relatives would provide a small amount of new capital. *Id.* at 532. The bankruptcy judge lifted the automatic stay and the district court affirmed for failure to show a realistic prospect of reorganization. The Eighth Circuit agreed, but also stated, with apparent approval, that "the district court recognized the continuing validity of the 'new value' exception to the absolute priority rule, but concluded the Andersons' vague testimony concerning the contribution by unnamed relatives of an unspecified amount of money was insufficient to meet their burden of showing a contribution that was reasonably compensable and measurable," and cited Ahlers and Blankenmeyer for this general proposition. *Id.* at 532-533. *Cf. In re* Lumber Exch. Bldg. Ltd. Partnership, 968 F.2d 647 (8th Cir. 1992) (affirming bankruptcy court's dismissal of case on different grounds, but silent on bankruptcy court's holding that new value exception had no force under Code).

[1409] *In re* Bryson Properties, XVIII, 961 F.2d 496 (4th Cir. 1992), *cert. denied*, 506 U.S. 866 (1992). The court expressed concern that equity participation entailed an exclusive right to bid, which could be construed as an impermissibly-retained property right in contravention of the absolute priority rule. The court went on to say, however, that even if the new value exception did exist, "it would not be so expansive as to apply under the facts of this case . . . . Here, the debtors have carried their opportunity for self-dealing too far." *Id.* at 505.

[1410] *In re* Drimmel, 987 F.2d 1506 (10th Cir. 1993). The Tenth Circuit affirmed a bankruptcy court's denial of confirmation of the farm owners' new value plan. The bankruptcy court had held that the debtors did not prove their new contribution would have qualified, but more importantly, the new value exception did not survive the Code's enactment. Without taking any position on the bankruptcy court's latter holding, the Tenth Circuit merely ruled that the debtors had not provided sufficient proof that they fulfilled the Los Angeles Lumber requirements. *Id.* at 1510.

ruled in *Greystone* that the new value exception did not survive enactment of the 1978 Code, but on reconsideration the Fifth Circuit withdrew that portion of the opinion.[1411]

Without definitive guidance available outside of the Ninth and Seventh Circuits on whether nonconsensual new value can be "fair and equitable," lower courts in other circuits have adopted their own analyses. A recent trend among bankruptcy and district courts is an almost uniform recognition of the new value exception.[1412] Some bankruptcy and district courts have held that the new value exception did not survive enactment of the 1978 Bankruptcy Code, although some of these decisions were negated by the Ninth Circuit's *Bonner Mall* decision.[1413]

[1411] *In re* Greystone III Joint Venture, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992).

[1412] Every one of the last thirteen published decisions dealing with confirmations of cramdown plans using the new value exception to the absolute priority rule (about a year's worth of cramdown confirmation opinions) recognized the continuing viability of the new value exception and applied some version of the Case v. Los Angeles Lumber requirements, although only three plans were confirmed. Overall, of the 126 opinions published since the United States Supreme Court made an ambiguous statement regarding the continued validity of the absolute priority rule in Norwest Bank Worthington v. Ahlers, 485 U.S. 197 (1988) (expressly reserving question of whether new value exception survived enactment of 1978 Code), only 11 have confirmed new value plans without being reversed or vacated. J. Ronald Trost, Joel G. Samuels, & Kevin T. Lantry, Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification, printed in materials for New York Univ. School of Law Workshop on Bankruptcy and Business Organizations XXIII, 1102 (August 26-28, 1997). *See also In re* Beauchesne, 209 B.R. 266 (Bankr. D. N.H. 1997); *In re* Way Apartments, D.T., 201 B.R. 444 (N.D. Tex. 1996); *In re* Mission Heights Investors Ltd. Partnership, 202 B.R. 131 (Bankr. D. Ariz. 1996); BT/SAP v. Coltex Loop Centr. Three Partners, 203 B.R. 527, 535 (S.D.N.Y. 1996); *In re* Grandfather Mountain Ltd, 207 B.R. 475, 492 (Bankr. M.D.N.C. 1996); *In re* Graphic Communications, Inc., 200 B.R. 143, 150 (Bankr. E.D. Mich. 1996); *In re* Homestead Partners, Ltd., 197 B.R. 706, 716 (Bankr. N.D. Ga. 1996). *See also In re* Bonner Mall Partnership, 2 F.3d 899 (9th Cir. 1993), *motion to vacate denied and cert. dismissed*, 513 U.S. 18 (1994); *In re* Sovereign Group 1985-27, Ltd., 142 B.R. 702, 709 (E.D. Pa.1992); *In re* Waterville Valley Town Square Assoc., 208 B.R. 90 (Bankr. D.N.H. 1997); *In re* Applied Safety, Inc., 200 B.R. 576 (Bankr. E.D. Pa. 1996); *In re* Gramercy Twins Assocs., 187 B.R. 112 (Bankr. S.D.N.Y. 1995);*In re* Haskell Dawes, Inc., 199 B.R. 867, 871-72 (Bankr. E.D. Pa.1996); *In re* Union Meeting Partners, 165 B.R. 553 (Bankr. E.D. PA. 1994), *aff'd*, 52 F.3d 317 (3d Cir.1995); *In re* Wynnefield Manor Assocs., L.P., 163 B.R. 53, 56 (Bankr. E.D. PA. 1993); *In re* SM 104 Ltd., 160 B.R. 202 (Bankr. S.D. Fla.1993); S.A.B.T.C. Townhouse Ass'n Inc., 152 B.R. 1005, 1008 (Bankr. M.D. Fla.1993); *In re* 222 Liberty Assocs., 108 B.R. 971, 983-85 (Bankr. E.D. Pa.1990).

[1413] *See*, e.g., *In re* A.V.B.I., Inc., 143 B.R. 738, 741 (Bankr. C.D. Cal. 1992) (consensual new value plans should be encouraged, but statutory language and legislative history reveal that new value exception was omitted intentionally from § 1129(b)), *In re* Bonner Mall, 2 F.3d 899 (9th Cir. 1993) cert. granted 114 S.Ct. 681 (1994); *In re* Outlook/Century, Ltd., 127 B.R. 650, 656 (Bankr. N.D. Cal. 1991) (plain language precludes new value exception), *overruled by* Bonner Mall, *supra*; *In re* Lumber Exchange Ltd. Partnership, 125 B.R. 1000 (Bankr. D. Minn.) (granting relief from stay

A recommendation to settle the long-debated question on the new value exception would benefit the collective negotiation process. Extensive judicial efforts have been expended for little gain. With a statutory clarification, litigation and the attendant costs and delays could be reduced, and parties could negotiate for out-of-court settlements with greater certainty and speed. While litigation cannot be completely avoided in confirmation of a cramdown plan, it should focus on the plan, not on legal rules that should be settled at a policy level.

The Proposal adds an important restriction that goes beyond the requirements imposed by the Ninth and Seventh Circuits and many lower court decisions, thereby requiring that any new value plan be exposed to the marketplace to test its valuation. As stated previously, a primary source of concern about the new value exception has been the lack of competition in the process. This Proposal should assuage the concerns of courts and commentators that the new value exception would permit insiders to acquire the "going concern" value of the debtor in an exclusive private sale when the sellers, the impaired creditor classes, do not like the proposed purchase terms.[1414] Through lifting exclusivity, the Commission seeks to provide additional assurance that unsecured creditor cramdown plans will not transfer value to old equity for less than full consideration in contravention of the absolute priority rule.

Lifting Exclusivity versus Equity Auctions. In an effort to eliminate what is perceived as the old equity holders' exclusive right to bid, some courts have endorsed or ordered auctions of the debtor's equity, where anyone can bid.[1415] The difficulty with the auction approach is that it divests the court of its own independent review of the factors required for confirmation of a new value plan and requires establishing

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for lack of likelihood of confirmation, holding that new value exception had no force under Code), *aff'd*, 134 B.R. 354 (D. Minn. 1991), *aff'd*, 968 F.2d 647 (8th Cir. 1992) (not addressing absolute priority or new value issues); *In re* Winters, 99 B.R. 658, 663 (Bankr. W.D. Pa. 1989) ("Congress with apparent deliberation did not mention "infusion of new capital" as a consideration in applying the fair and equitable test" when it changed to class voting); *In re* Ribs Auto Sales, Inc., 140 B.R. 390 (Bankr. E.D. Va. 1992) (stating in dictum that there is no exception to absolute priority rule); *In re* Rudy Debruycker Ranch, Inc., 84 B.R. 187 (Bankr. D. Mont. 1988); *In re* Maropa Marine Sales Serv. & Storage, Inc., 90 B.R. 544 (Bankr. S.D. Fla. 1988).

[1414] *In re* Bryson Properties XVIII, 961 F.2d 496, 504 (4th Cir.) (partners inappropriately would receive exclusive bidding right), *cert. denied*, 506 U.S. 866 (1992).

[1415] *In re* Homestead Partners, Ltd., 197 B.R. 706 (Bankr. N.D. Ga. 1996) (endorsing equity auction); *In re* Hickey Properties, Ltd., 181 B.R. 171 (Bankr. D. Vt., 1995) (plan must provide for sale of equity interest to highest bidder at auction); *In re* Overland Park Merchandise Mart Partnership, 167 B.R. 647 (Bankr. D. Kan. 1994) (auctioning of controlling share of equity acceptable, but minimum bid insufficient); *In re* Ropt Ltd. Partnership, 152 B.R. 406 (Bankr. D. Mass. 1993) (ordering equity auction); *In re* Bjolmes Realty Trust, 134 B.R. 1000, 1010-1012 (Bankr. D. Mass. 1991) (ordering equity auction). *But see* SM 104 Ltd.,160 B.R. 202, 226 (Bankr. S.D. Fla. 1993) (equity auction unrealistic due to thin market and securities regulations).

an auction process and reorganization plan format acceptable to the debtor as well as to potential bidders. The debtor can structure the terms of the auction to advantage old equity. If no one bids at the auction except the debtor, the debtor's bid is accepted. Auctions, without more, do not eliminate the possibility of self-dealing.

The Commission does not endorse the equity auction approach because terminating exclusivity is a preferable method of exposing the debtor to the market. Lifting exclusivity maintains a relationship between equity and creditors that is more in keeping with the rules of absolute priority because the court retains a significant, independent role in reviewing the debtor's new value plan: the plan must satisfy the *Case v. Los Angeles Lumber Products* factors, including the requirement that the price paid is reasonably equivalent to the value received.[1416] Permitting others to propose a plan of reorganization, as the Commission proposes, is superior to an equity auction because it protects creditors in two ways, in effect: market exposure in a functioning market, and court review in the absence of a market.

Lifting Exclusivity versus Credit Bidding. Other courts and commentators have recommended the expanded use of credit bidding, particularly in the context of single asset real estate cases in cramdown plans. In effect, a secured creditor could bid in any amount up to the face value of its claim for the business. This approach has several problems. First, there is no reason to believe that a credit bid bears any relation to the actual value of the property. If a creditor holding a secured claim concludes either that the unsecured portion of its claim is unlikely to be paid by the estate or if the creditor decides it prefers to foreclose on the property rather than permit the debtor to reorganize, the creditor will bid the full amount of the claim, irrespective of the value of the collateral. Second, because a single secured creditor is not likely to have a security interest in the entire business, any creditor that is permitted to obtain the entire business based on a credit bid for only some of the assets will be able to capture going concern value in excess of what otherwise would be the creditor's allowed secured claim. That value should be distributed to the unsecured creditors. The use of credit bidding in cramdown plans would significantly redistribute power away from unsecured creditors, equity holders and debtors and toward a single secured creditor.

Even without credit bidding, a secured creditor still has a significant advantage in bidding for property. The value of any bid—including the secured creditor's bid—will be distributed back to the secured party. The important point, however, is that whatever is bid in excess of the value of the collateral is available either for distribution to the unsecured creditors or is a contribution of new capital to maintain operation of the business. Prohibitions on credit bidding simply mean that the secured

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[1416] *See generally* Nicholas L. Georgakopoulos, *New Value, Fresh Start*, 3 STAN. J. L. BUS. & FIN. (1997) (if no outsiders bid at auction, only bidder who appreciates firm's going concern value may be old equity holder).

creditor will not be permitted to bid the unsecured portion of its debt for full value, which puts the unsecured debt of a secured creditor on par with the unsecured debt of all other creditors.

Credit bidding violates the principle of equality of distribution among all legally similar creditors. It also undercuts reorganization efforts because it provides the leverage to a secured creditor, by virtue of its unsecured portion of debt, to seize any business in which it is not paid in full. This essentially eviscerates the ability to confirm a cramdown plan over the objection of a secured creditor.

Applicability to Large and Small Cases Alike. The Supreme Court originally enunciated the absolute priority rule and the new value exception in the context of equity receiverships and railroad reorganizations because of concerns that management and shareholders would squeeze out intermediate level creditors and misallocate value.[1417] By contrast, the legal development of the new value exception under the Bankruptcy Code has been shaped primarily by small Chapter 11 cases, such as family farms, other small businesses, and single asset real estate ventures. This is particularly ironic given the fact that the Bankruptcy Act of 1898 did not impose the absolute priority rule in Chapter XI cases because small businesses were not expected to be able to reorganize without full participation by old equity. Because small business owners and their managers frequently are one and the same in small business cases, the absolute priority rule was deemed inapplicable.[1418]

The concerns involved in the reorganization of the typical small business in financial trouble are far removed from the issues facing today's Chapter 11 debtor. Yesterday's concerns with absolute priority in large railroad equity receivership cases have evolved to become today's focus on general concerns about whether potentially nonviable small entities can and should be pushed out of Chapter 11 quickly. Small business and single asset cases undoubtedly should be scrutinized carefully, like all bankruptcy cases, but a strict interpretation of the absolute priority rule may be too blunt an instrument to do so. Broader economic and social policy do not support foreclosing any possibility of reorganizing a family farm or a "mom-and-pop" store by permitting its owners to make new contributions and to retain ownership.

[1417] *See* Northern Pacific Ry. v. Boyd, 228 U.S. 482 (1913); Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445, 455 (1926); Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738 (1988); John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 969 (1989).

[1418] "[I]n recognition of the fact that prior owners may sometimes be the best 'buyers' of a reorganized corporation, courts are reluctant to squeeze the old owners out entirely . . . This reluctance is especially evident when the debtor is a closely held corporation or a sole proprietorship." *In re* Wabash Valley Power Ass'n, 72 F.3d 1305 (7th Cir. 1995).

By putting forth the general principle that continued involvement of old equity is not precluded *per se* in nonconsensual plans, while ensuring adequate valuation and the opportunity for competition, the proposed rules will provide appropriate guidance in both large and small cases for fair and balanced negotiations.

Competing Considerations. The Commission's Proposal gives creditors the tools to guard their rights by enabling them to propose or support competing plans. In addition, creditors will continue to enjoy the protection of court review of plans to determine equivalence of value received. However, the Proposal does not guarantee additional affirmative protection in the event that creditors reject a competing plan. Other creditors might not endorse a competing plan that properly values the business. In such a case, the Proposal does not eliminate all risk of equity undervaluation. This problem is more acute whenever creditors are inactive or poorly informed. While the Proposal constricts, rather than expands, a debtor's powers under current law in many courts, some might argue that these constrictions may be inadequate to balance the rights of the parties.

Because the proposed changes would affect plan negotiations, some might be concerned that old equity holders may be the new hold-outs and threaten to foil a consensual plan unless the creditors permit equity holders to participate in the reorganized entity. To the extent that the proposed provisions legitimize the negotiating leverage of old equity holders, they might allow them to take something from the reorganization at the expense of unsecured creditors.

Of course, the possibility of equity exercising hold-out leverage to participate in a reorganization exists under current law.[1419] As several studies indicate, consensual reorganization plans for publicly traded companies routinely are not in accord with the absolute priority rule.[1420] These studies show that in efforts to avoid

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[1419] *See, e.g.,* Lucian Bebchuk, *A New Approach to Corporate Reorganizations*, 101 HARV. L. REV. 775, 780 (1988) (noting deliberate deviation from entitlements when equityholders use power to delay to extract plan giving them more than value to which they are entitled., even when creditors are entitled to all reorganization value), *citing* J. Ronald Trost, *Corporate Bankruptcy Reorganization: For the Benefit of Creditors or Stockholders*?, 21 UCLA L. REV. 540, 550 (1973).

[1420] Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 611 (1993); Lawrence A. Weiss, *Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims*, 27 J. FIN. ECON. 285 (1990) (in review of 37 publicly held companies, strict priority of claims was violated in 29 cases); Allan C. Eberhart, *Security Pricing and Deviations from the Absolute Priority Rule in Bankruptcy Proceedings*, 45 J. FIN. 1457 (1990) (of 24 publicly held corporations in bankruptcy with creditor deficit, shareholders in 23 of cases received payments in violation of absolute priority rule); Julian R. Franks & Walter N. Torous, *An Empirical Investigation of U.S. firms in Reorganization*, 44 J. FIN. 747 (1989) (payments to shareholders in excess of what they would receive under absolute priority rule is essentially purchases by creditors of shareholders' option to delay reorganization and impose future legal and administration costs on creditors).

the litigation and other costs associated with a cramdown, debtors and creditors agree to give some value to old equity holders to obtain affirmative votes, even though equity is without value and should be wiped out. This often requires that equity be paid its nuisance value. Some might question whether the Commission's Proposal unfairly increases the leverage of the equity holders. If old equity holders actually invoke the new value exception, they will have to provide new value. In most of the publicly held cases recently studied, old equity has tried to maximize its hold-up value, but has not offered additional new value. Thus, at least in the context of the widely held publicly traded debtor, this Proposal is unlikely to change negotiating positions based on hold-out powers.

Some argue that deviations from absolute priority are too costly and result in increases in the cost of borrowing, on the theory that lenders adjust their rates to reflect the fact that equity may capture some value that would otherwise belong to them. A related argument is that failure to enforce absolute priority will affect investment decisions, driving up the cost of capital and distorting allocations between equity, secured debt, and unsecured debt.[1421] While these arguments are based on perfect market theories that may or may not be sound in practice, the concerns should be minimized or eliminated by the termination of exclusivity in cramdown cases so that the market can determine any value to be exchanged in return for ownership of the post-reorganization debtor. So long as the company is not undervalued, there has been no distortion created by diversion of value from one holder to another. Of course, when creditors fail to monitor their own interests, there is risk of undervaluation. A rule that flatly precludes old equity from making post-filing contributions likely would result in more liquidations, which yield a loss of going concern value and may do more long-term injury to all creditor interests, which, by the same market-based reasoning, would increase the overall cost of capital.

Others might argue that a new value exception no longer is necessary to constrain the extraordinary holdout power of individual creditors because the absolute priority rule applies only to dissenting classes rather than to all classes.[1422] This argument rests on the premise that the calculation of an allowed secured claim, adequate protection, and the provisions of sections 1123 and 1129 give inadequate power to creditors. However, the question is not just one of debtor versus creditor, but also creditor versus creditor and even community versus creditor. The policy decision supporting bankruptcy reorganizations for the benefit of both debtors and

[1421] *See generally* Robert K. Rasmussen, *The Ex Ante Effects of Bankruptcy on Investment Incentives*, 72 WASH. U. L.Q. 1159 (1994); Alan Schwartz, *The Absolute Priority Rule and the Firm's Investment Policy,* 72 WASH. U. L. Q. 1213 (1994); Barry E. Adler, *Bankruptcy and Risk Allocation,* 70 CORNELL L. REV. 439 (1992).

[1422] *See* J. Ronald Trost, *Corporate Bankruptcy Reorganizations: For The Benefit of Creditors or Shareholders?*, 21 UCLA L. REV. 540, 550-51 (1973).

creditors, to preserve jobs and other ties within communities, are supported by encouraging new equity investment—at a fair price—in all kinds of Chapter 11 cases.

Some might argue that vague rules, which foster uncertainty, force parties to settle consensually and thus the new value corollary should not be made explicit in the statute. This argument, however, may prove too much. No one advocates leaving all bankruptcy rules vague, and the advantages of leaving this rule vague rather than any other is unclear. Because the application of the new value corollary entails a factual inquiry, there is ample room for negotiation. In any event, the principle of most of the Recommendations throughout the Commission report is that vague rules promote unnecessary litigation and cost, and the Commission recommends eliminating vague rules whenever possible. As this competing consideration demonstrates, however, others may disagree with that approach.

2.4.16 *Classification of Claims*

Section 1122 should be amended to provide that a plan proponent may classify legally similar claims separately if, upon objection, the proponent can demonstrate that the classification is supported by a "rational business justification."

The claims of creditors and interests of equity holders are grouped into classes for treatment under a plan of reorganization and voting on that plan.[1423] These classes are not determined automatically or by the court; rather, a Chapter 11 plan proponent is required to designate classes of claims and classes of interests in its plan.[1424] Section 1122 governs a plan proponent's flexibility in determining what claims can be placed together in a class. This provision states explicitly that classes must be internally homogenous: claims may not be classified together unless they are "substantially similar" to one another.[1425] For example, nonpriority unsecured claims

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[1423] 11 U.S.C. § 1123(a)(4) (1994) (plan shall "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment"); *id.* at § 1126(c) (1994) (determining number and amount of affirmative votes on plan for class to have accepted plan).

[1424] 11 U.S.C. § 1123(a) (1994).

[1425] Section 1122 governs the classification of claims and interests, providing:

> (a) Except as provided in subsection (b) of this section, a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interest of such class.
> (b) A plan may designate a separate class of claims consisting only of every unsecured claim that is less than or reduced to an amount that the court approves as reasonable and necessary for administrative convenience.

cannot be placed in the same class as priority wage claims. However, section 1122 does not require that all substantially similar claims must be classified together.

The ability to group claims held by general unsecured creditors into multiple classes rarely presents significant difficulties in consensual cases. Indeed, this ability benefits creditors by enabling the debtor to put tort claimants, for example, in a separate class to pay those claims out of a trust while trade claimants are paid in cash directly by the debtor and unsecured bank claimants are paid in short-term notes.

However, this statutory provision has raised problems in the context of nonconsensual cases, particularly single asset real estate cases.[1426] In a typical single asset Chapter 11 case, the mortgage holder is undersecured and has elected to vote the large unsecured portion of its claim with the general unsecured claims.[1427] A prerequisite to plan confirmation is that one impaired class of claims vote in favor of the plan.[1428] The size of the deficiency claim usually dwarfs the other unsecured claims. Thus, if the mortgage holder's unsecured claim is classified with the general unsecured claims, it will control the voting for the entire class of unsecured creditors, such as trade debt, thus the plan would necessarily fail. A single asset real estate debtor often will attempt to classify its small amount of trade debt separately from the mortgage holder's unsecured deficiency claim, knowing that its trade creditors are likely to vote in favor of the plan, creating the opportunity for the debtor to attempt to cram down the plan over the objection of its largest and most impaired creditor.

The debate surrounding the question of whether the single asset real estate debtor can pursue this classification scheme has produced a tremendous amount of litigation, published case law, and commentary. Bitter disputes, both practical and theoretical, have multiplied. Nonetheless, several common themes have emerged from this debate, and they form the basis of the Commission's Recommendation. First, there is almost uniform agreement that it is improper to classify claims with the sole aim of separating assenting creditors from dissenting creditors.[1429] Second, any rule

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11 U.S.C. § 1122 (1994).

[1426] As of 1994, one bankruptcy court counted over one hundred and fifty published opinions that discussed the question of whether section 1122(a) permitted separate classification of similar claims. *In re* Bloomingdale Partners, 170 B.R. 984, 988 n.7 (Bankr. N.D. Ill. 1994).

[1427] *See* 11 U.S.C. § 1111(b) (1994).

[1428] *See* 11 U.S.C. § 1129(a)(10) (1994).

[1429] *See, e.g.*, Boston Post Road Ltd. Partnership v. FDIC, 21 F.3d 477, 483 (2d Cir. 1994) ("debtor [must] adduce credible proof of legitimate reason . . . for segregating the FDIC's unsecured claim from the unsecured claims of [debtor]'s trade creditors"), *cert. denied*, 513 U.S. 1109 (1995); *In re* Greystone III Joint Venture, 948 F.2d 134, 139 (5th Cir. 1991) ("if section 1122(a) permits devised to address the single asset problem should not upset a process of classification that works well in the vast majority of cases. The classification rules are applicable to a wide spectrum of business debtors with various types of creditors, and thus the rules should retain flexibility to accommodate the range of businesses served by the system.

The conflicts in the case law between circuits, and even within the circuits, on the appropriate classification standards create unpredictability in the plan negotiation process, which results in much needless litigation. A uniform rule is needed. Rather than developing an entirely new approach, which could cause unwarranted disruption, the Commission endorses the test that has been employed by several circuit courts of appeals. This test permits a debtor to classify groups of claims separately for business reasons *and* prohibits a debtor from separately classifying claims for the sole purpose of engineering an assenting impaired class to cram down a plan. Under the Commission's Recommendation, the Bankruptcy Code expressly would permit a plan proponent to classify legally similar claims (*e.g.*, unsecured bank debt and past-due-pension contributions) separately and treat them differently if, upon objection, the proponent could establish it had a legitimate business reason to support the classification. Under Rule 3013 of the Federal Rules of Bankruptcy Procedure, creditors would be able to challenge classification prior to the plan confirmation stage, and the proponent's justification for separate classification would have to be supported by credible proof. Justification for separate classification would be premised on disparate forms of treatment, such as immediate payment for employees and payment over time for commercial creditors, and the types of permissible distinctions made between classes might include the timing of payment or the form of payment (cash or debt instruments). If the proponent did not have a business reason to treat two substantially similar claims differently, the classification scheme would be prohibited. This approach provides flexibility for a business to meet its reorganization needs without sacrificing the interests of creditors overall. The Proposal would not alter subsection (b) of section 1122 that deals with "administrative convenience" classes.

In addition to the rational business justification requirement, other significant statutory constraints on the treatment of claims that already are in place would safeguard creditors in a cramdown plan. If the plan unfairly discriminated against an objecting impaired class, the plan could not be confirmed over the dissent of that class.[1430] A strict construction of the unfair discrimination requirement prevents

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classification of 'substantially similar' claims in different classes, such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims"), *cert. denied*, 506 U.S. 821 (1992).

[1430] 11 U.S.C. § 1129(b)(1) (1994): "Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with improper distinctions in treatment among claimholders.[1431] As discussed in the context of the prior Recommendation, a nonconsensual plan also must be "fair and equitable" to objecting classes of claims.

The Need for Clarification. Under the Bankruptcy Act of 1898, as amended by the Chandler Act in the 1930s, the court classified claims and interests. In cases under Chapter X and Chapter XII, the court did so according to the "nature of their respective claims."[1432] Chapter XI did not impose the same limitations and expressly validated provisions for the division of unsecured debts into classes and the treatment thereof in different ways or upon different terms.[1433] Chapter 11 of the Bankruptcy Code of 1978 draws on elements of both Chapters X and XI and folds in cases formerly covered in Chapter XII, but it does not indicate which, if either, of the two prior approaches to classification of similar claims was incorporated into Chapter 11 of the Bankruptcy Code. The legislative history is ambiguous on the issue of separate

respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."

[1431] *See In re* Ambanc La Mesa Ltd. Partnership, 115 F.3d 650 (9th Cir. 1997) (applying four part test to determine whether discrimination is unfair).

[1432] 11 U.S.C. § 597 (repealed 1979); *In re* Los Angeles Land & Inv., Ltd., 282 F. Supp. 448 (D. Haw. 1968), *aff'd*, 447 F.2d 1366 (9th Cir. 1971); *see also* Scherk v. Newton, 152 F.2d 747, 751 (10th Cir. 1945) ("classification should be based on substantial differences in the nature of claims. All creditors of equal rank with claims against the same property should be placed in the same class"); Brinkley v. Chase Manhattan Mortgage and Realty Trust (*In re* LeBlanc), 622 F.2d 872, 878 (5th Cir. 1980) ("as a general rule, the classification in a plan should not do substantial violence to any claimant's interest. The plan should not arbitrarily classify or discriminate against creditors") *reh'g denied*, 627 F.2d 239 (5th Cir. 1980); *accord In re* Palisades-on-the-Desplaines, 89 F.2d 214 (7th Cir. 1937).

[1433] 11 U.S.C. § 757(1) (repealed 1979).

classification of similar claims.[1434] Scholarly commentators have written extensively on this ambiguous provision.[1435]

[1434] The 1973 Commission Report recommended "[i]f necessary for the purpose of the plan or its acceptance, on the request of any party in interest, the administrator shall designate classes of creditors and equity security holders which are of substantially similar character and the members of which enjoy substantially similar rights . . . except that the administrator may create a separate class of creditors having unsecured claims of less than $100 for reasons of administrative convenience." Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 93-137, pt. II, at 241 (1973). The House Judiciary Committee reported that section 1122 codified "current case law surrounding the classification of claims and equity securities. It requires classification based on the nature of the claims or interests classified, and permits inclusion of claims or interests in a particular class only if the claim or interest being included is substantially similar to the other claims or interests of the class." H.R. REP. NO. 95-595, (1977). According to courts, this legislative history provides little guidance. *See*, *e.g.*, *In re* Boston Post Road Ltd. Partnership, 21 F.3d 477, 483 (2d Cir. 1994) (analysis of legislative history "sheds little light"), *cert. denied*, 513 U.S. 1109 (1995); *In re* Jersey City Med. Ctr., 817 F.2d 1055, 1060 (3d Cir. 1987) (legislative history "inconclusive"); *In re* U.S. Truck Co., 800 F.2d 581, 586 (6th Cir. 1986) ("Congress has sent mixed signals").

[1435] *See*, *e.g.*, Bruce A. Markell, *Clueless on Classification: Toward Removing Artificial Limits on Chapter 11 Claim Classification*, 11 BANKR. DEV. J. 1 (1995) (separate classification permissible unless dissenter establishes that class includes claims with different non-bankruptcy liquidation priorities); Stefan A. Riesenfeld, *Classification of Claims and Interests in Chapter 11 and 13 Cases*, 75 CAL. L. REV. 391(1987) (promotion of successful reorganizations requires flexible classification so long as classes are treated differently and there is no unfair discrimination); Linda J. Rusch, *Gerrymandering the Classification Issue in Chapter 11 Reorganizations*, 63 U. COLO. L. REV. 163 (1992)(separate classification appropriately prevents dissenting creditors from exercising veto power over reorganization, leaving impartial judge to determine whether reorganization satisfies Code requirements); David Gray Carlson, *The Classification Veto in Single-Asset Cases under Bankruptcy Code Section 1129(a)(10)*, 44 S.C. L. REV. 565 (1993) (in cases involving a dominant secured creditor, flexible classification is desirable because of different legal rights); *see also* Scott F. Norberg, *Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification*, 69 AM. BANKR. L. J. 119, 125 (1995) (classification exists only to maintain the rights of creditors under the absolute priority rule; section 1122 permits separate classification of similar claims only insofar as is consistent with enforcing absolute priority rule and encouraging settlement); Louis S. Robin, *Classification of Claims: An Examination of Disregarded Legislative History*, 98 COM. L.J. 225 (1993)(broad discretion in classification of claims is supported by legislative history and Bankruptcy Act); Peter E. Meltzer, *Disenfranchising the Dissenting Creditor Through Artificial Classification or Artificial Impairment*, 66 AM. BANKR. L.J. 281 (1992) (because the focus is on claim, not interests of claimholder, strict classification rules should apply); Thomas C. Given & Linda J. Philipps, *Equality in the Eye of the Beholder--Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 OHIO ST. L.J. 735 (1982) (projects that courts will support separate but equal plans if accepted by the separate classes of claimholders and that equitable discrimination between claims will be more contentious); William Blair, *Classification of Unsecured Claims in Chapter 11 Reorganization*, 58 AM. BANKR. L.J. 197, 211-17 (1984); John C. Anderson, *Classification of Claims and Interests in Reorganization Cases Under the New Bankruptcy Code*, 58 AM. BANKR. L.J. 99, 119 (1984). *See also* Richard L. Epling, *Separate Classification of Future Contingent and Unliquidated Claims in Chapter 11*, 6 BANKR. DEV. J. 173 (1989) (section 1122 needs no amendment, but Code should expressly permit separate classification

Not surprisingly, litigation over separate classification has yielded a wide array of responses. The confirmability of a plan's classification method may well depend first on the test used by the court reviewing the plan. A few courts have concluded that section 1122 permits unrestricted separate classification of similar claims, while some courts have taken the opposite view and held that separate classification of similar claims is prohibited *per se*. Most courts have taken a middle ground, hypothesizing that "reasonable" separate classification of similar claims is permissible, but that some limits are necessary so classification is reasonable and comports with a basic sense of fairness.[1436] However, these courts have adopted disparate approaches to determine what is reasonable: some have focused on the proponent's business purpose for separate classification, while others have based their determinations on the "nature" of the claims and the extent to which these claims warrant a separate voting voice. The extent to which bankruptcy court determinations on classification have been upheld often depends also on the extent of review undertaken by the reviewing court. Some courts review classification decisions *de novo* (if classification is deemed a question of law), others review only for clear error (if classification is deemed a question of fact), and still other courts use a different standard depending on whether the bankruptcy court permitted or disallowed the classification.[1437]

The confusion and resulting case law have been, in large part, reactions to factors peculiar to single asset real estate cases. However, section 1122 applies to classification in all Chapter 11 and Chapter 9 cases and thus the decisions in the single asset cases, and the uncertainty they cause, have a more widespread application. As a result, plan proponents receive little guidance as to how they can structure their plan repayments, and parties have less confidence regarding their negotiating positions when they bargain with debtors.

Courts Permitting Unrestricted Separate Classification of Similar Claims. Courts reading section 1122(a) literally have determined that nothing in the present Code prevents debtors from dividing similar claimants into multiple classes.[1438] This

of future claims, so long as this power is tempered by the unfair discrimination provision, so that a debtor cannot create a separate class solely to cramdown plan).

[1436] Courts' holdings on separate classification "have turned more on notions of basic fairness and good faith. Indeed, most courts seem to base their rulings less on the language of § 1122 than on their view that separate classification is usually done to manipulate the voting." *In re* SM 104 Ltd., 160 B.R. 202, 217 (Bankr. S.D. Fla. 1993).

[1437] *See* Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310, 1313 (8th Cir. 1987) (denial of classification motion not clearly erroneous).

[1438] "Concern that classification of similar claims not be used to gerrymander voting has blossomed into a line of authority in which plan proponents routinely are required to justify separate approach appears to be the most faithful to the statutory language. However, because this interpretation gives debtors unfettered authority to classify substantially similar claims into innumerable classes, this interpretation would not preclude separate classification to create an accepting class for confirmation purposes. The courts taking this approach have advocated that the unfair discrimination prohibition in section 1129(b) is the proper tool for courts and dissenting classes of claims to challenge improper and unfair distinctions among classes in nonconsensual plans.[1439] However, the unfair discrimination prohibition is not a cure-all when plans separately classify claims for voting purposes but provide identical treatment to the classes, which generally signifies that classes have been gerrymandered.[1440]

Courts Prohibiting Separate Classification of Similar Claims. Some courts and commentators have suggested that substantially similar claims cannot be classified separately for any purpose.[1441] Although a flat prohibition has facial appeal for its

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classification of similar claims or such classification is forbidden regardless of whether gerrymandering is an issue. In short, judicial interpretation of § 1122(a) to avoid gerrymandering has resulted in a rewriting of the section." *In re* City of Colorado Springs, 187 B.R. 683 (Bankr. D. Col. 1995)); *In re* ZRM-Oklahoma Partnership, 156 B.R. 67, 70-71 (Bankr. W.D. Okl. 1993) ("Whether Congress has wisely balanced the conflicting interests at play here is not a question the judiciary is competent to decide."); *In re* Huckabee Auto Co., 33 B.R. 132, 137 (Bankr. M.D. Ga. 1981) (plan proponent not required to classify similar claims together); *In re* Rochem, Ltd., 58 B.R. 641, 642 (Bankr. D.N.J. 1985) (upholding separate classification of tort creditor, trade creditors, and law firm because Code does not require collective classification of similar claims). *See also In re* AOV Ind., Inc., 792 F.2d 1140, 1150 (D.C. Cir. 1986) (language of section 1122 "does not require that similar claims must be grouped together" but "logistics and fairness dictate consolidation rather than proliferation of classes, so long as they are internally homogenous"), citing Scherk v. Newton, 152 F.2d 747, 751 (10th Cir. 1945); Barnes v. Whelan, 689 F.2d 193, 201 (D.C. Cir. 1982) (sections 1122(a) and 1322(b)(1) did not preclude debtor from separately classifying co-signed debts), *citing* 5 COLLIER ON BANKRUPTCY ¶ 1122.03(1)(b) at 1122-6 (Lawrence P. King et al. eds., 15th ed. 1982). *See also In re* Gato Realty Trust Corp., 183 B.R. 15 (Bankr. D. Mass. 1995) (law did not preclude debtor from isolating impaired accepting class).

[1439] *In re* City of Colorado Springs, 187 B.R. 683, 689 (Bankr. D. Col. 1995) (improper treatment of classes is addressed in "unfair discrimination analysis" of section 1129(b)); *In re* ZRM-Oklahoma Partnership, 156 B.R. at 70-71 (Bankr. W.D. Okl. 1993) (section 1129(b) prohibition on unfair discrimination, section 1129(a)(3) good faith requirement, section 1129(a)(7) best interest test, and section 1111(b) recourse election adequately address improper treatment). *See also* Barnes v. Whelan, 689 F.2d at 201 (D.C. Cir. 1982) (separate classification of co-signed debts permissible under sections 1122 and 1322, but plan unfairly discriminated).

[1440] One exception to this general rule would be in a prepackaged plan of reorganization when the debtor solicits from one class but not another prior to filing the bankruptcy petition. *See* FED. R. BANKR. P. 3018(b) (1997).

[1441] *See* Granada Wines, Inc. v. New England Teamsters and Trucking Indus. Pension Fund, 748 F.2d 42, 46 (1st Cir. 1984) ("all creditors of equal rank with claims against the same property should be placed in the same class"), *citing In re* Los Angeles Land and Inv., Ltd., 282 F. Supp. 448, apparent ease of application, this simplicity quickly disappears in practice. Similar outcomes from court to court are not guaranteed under this rule because courts do not agree on whether particular types of claims are "substantially similar." The initial inquiry on "similarity" involves a case-by-case determination.[1442]

Cases decided under the flat prohibition rule, along with other cases in which substantial similarity is contested, demonstrate the rule's inherent shortcomings. Some courts believe that pension withdrawal liability is substantially similar to general unsecured claims, while others do not.[1443] Some courts believe that deficiency claims created by the section 1111(b) election are substantially similar to trade claims,[1444] but other courts disagree.[1445] If a creditor's claim is guaranteed by a nondebtor party, some courts conclude that the claim is not substantially similar to other unsecured claims, while others disagree.[1446] These types of questions already have been the

453 (D. Haw. 1968), aff'd, 447 F.2d 1366 (9th Cir. 1971); *see also In re* Mastercraft Record Plating, Inc., 32 B.R. 106, 108 (Bankr. S.D.N.Y. 1983) ("no authority for classifying similar claims differently other than § 1122(b) . . . . General unsecured claims are all alike"), *rev'd on other grounds*, 39 B.R. 654 (S.D.N.Y. 1984); *In re* Pine Lake Village Apt. Co., 19 B.R. 819, 829 (Bankr. S.D.N.Y. 1982), *reh'g denied*, 21 B.R. 478 (Bankr. S.D.N.Y. 1982) (section 1122(b) is "only exception expressed in the Code for separately designating unsecured claims"); *In re* S&W Enters., 37 B.R. 153, 158 (Bankr. N.D. Ill. 1984) (disallowing debtor's attempt to separately classify if not administrative convenience classes under section 1122(b)). *See also* Scott F. Norberg, *Classification of Claims Under Chapter 11 of the Bankruptcy Code: The Fallacy of Interest Based Classification*, 69 AM. BANKR. L J. 119, 125 (1995) (classification exists only to maintain the rights of creditors under the absolute priority rule; section 1122 permits separate classification of similar claims only insofar as is consistent with enforcing absolute priority rule and encouraging settlement).

[1442] *See In re* Bloomingdale Partners, 170 B.R. 984, 997 (Bankr. N.D. Ill. 1994) ("Similarity is not a precise relationship, and the elements by which we judge similarity or resemblance shift from time to time in bankruptcy . . . [it] is necessarily a case-by-case determination").

[1443] *Compare* Granada Wines, 748 F.2d 42, 47 (1st Cir. 1984) (pension fund withdrawal liability claims substantially similar to general unsecured claims) *with In re* the Mason & Dixon Lines, Inc., 63 B.R. 176 (Bankr. M.D.N.C. 1986) (pension fund withdrawal liability claims not substantially similar to general unsecured claims).

[1444] *See, e.g.*, *In re* Barakat, 99 F.3d 1520 (9th Cir. 1996), *cert. denied*, 117 S. Ct. 1312 (1997); *In re* Boston Post Road Ltd. Partnership, 21 F.3d 477 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995); *In re* Greystone III Joint Venture, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992).

[1445] *See*, e.g., *In re* Woodbrook Assocs., 19 F.3d 312, 318 (7th Cir. 1994) (artificially created section 1111(b) recourse claim not substantially similar to general unsecured claims), *reh'g denied*, 1994 U.S. App. Lexis 10784 (1994); *In re* Grandfather Mountain Ltd Partnership, 207 B.R. 475, 483 (Bankr. M.D.N.C. 1996); *In re* SM 104 Ltd., 160 B.R. 202, 218 (Bankr. S.D. Fla. 1993).

[1446] In *Steelcase, Inc. v. Johnson*, the bankruptcy court's approval of the separate classification of Steelcase's unsecured claim found not clearly erroneous because Steelcase was subject of conflicting interpretation and the disparities would be exacerbated if similarity became the exclusive and paramount inquiry. Additional questions can be contemplated. Holders of secured claims whose collateral is of little or no value may or may not be considered substantially similar to completely unsecured creditors. Parties also might litigate whether special state law collection rights that are given only to certain types of claimants, such as consumer protection claims, are legally dissimilar to bank debt, raising further questions of whether substantial similarity should be determined under bankruptcy law, state law, or other nonbankruptcy law.[1447]

Viewed from this perspective, prohibiting separate classification of substantially similar claims possibly could create more, rather than less, litigation. In addition, the test used to control separate classification may have an impact on the delay and cost of the appellate process. Many courts treat the initial question of substantial similarity as a question of law to be reviewed *de novo*,[1448] requiring greater

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partially secured in assets of another Chapter 11 debtor in which Johnson was the chief executive officer and the majority stockholder and ongoing litigation would have implication for Steelcase's treatment and may result in Steelcase getting paid earlier than other general unsecured claims, giving him little basis for complaint. Thus, Johnston's plan permissibly provided monthly installments equaling payment in full for most general unsecured creditors while Steelcase would receive lump sum full repayment contingent on litigation. 21 F.3d 323, 328 (9th Cir. 1994). *See also In re* Applied Safety, Inc., 200 B.R. 576 (Bankr. E.D. Pa. 1996) (approving separate classification based on difference between general creditors with regular debtor-creditor relationships and objecting creditor with setoff rights and pending lawsuit who would be paid at faster rate under plan). *But see In re* AOV Indus., Inc., 792 F.2d 1140, 1151 (D. C. Cir. 1985) (claim against co-debtor does not change "nature" of claim against debtor); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551, 563 (advocating that Steelcase v. Johnson be legislatively overruled because classification decisions should not be based on considerations other than rights against debtor or estate). *See also* 11 U.S.C. § 508 (1994) (implying that creditors with third party rights will be treated under Title 11 according to rights against debtor unless creditors actually collect debt from third party). *But see* Ralph R. Brubaker, *Bankruptcy Injunctions and Complex Litigation: A Critical Reappraisal of Non-Debtor Releases in Chapter 11 Reorganizations*, 1997 U. ILL. L. REV. (forthcoming) (arguing that creditors with recourse against third parties are not substantially similar to parties without rights against third parties).

[1447] While the state law characterization of claims is of primary relevance in other parts of the Code, *see* Butner v. United States, 440 U.S. 48 (1979), the Code has eradicated some of such legal distinctions in the Chapter 11 context. *See*, *e.g*., 11 U.S.C. § 1111(b) (1994); *In re* Greystone III Joint Venture, 948 F.2d 134, 141 (5th Cir. 1992) (section 1111(b) would be rendered meaningless if state law characterizations of claims were upheld), *cert. denied*, 506 U.S. 821 (1992); *see also* Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310 (8th Cir. 1987).

[1448] *See In re* Greystone III Joint Venture, 948 F.2d 134 (5th Cir. 1992) ("similarity in priority and legal attributes and the ultimate question whether treatment in the same or separate classes is necessary, are legal issues reviewable by our court de novo"), *cert. denied*, 506 U.S. 821 (1992); *In re* Woodbrook Assoc., 19 F.3d 312, 317 (7th Cir. 1994); *In re* Lumber Exch. Bldg. Ltd Partnership, 968 F.2d 647, 649 (8th Cir. 1992); *In re* Bryson Properties, XVIII, 961 F.2d 496, 502 resources for review as district courts and courts of appeals review the full factual records of bankruptcy court classification decisions.

Putting aside concerns about litigation, it is crucial to keep in mind that classification disputes arise primarily in highly contested, single asset real estate cases. A common sense approach therefore militates against a blanket prohibition of separate classification. In the vast majority of consensual plans and other cases, separate classification of groups of unsecured claimants occurs routinely. Such classification is not offensive to any party, and in fact can be critical to the success of the reorganization and the payment of all creditors. Indeed, the ability to classify groups of creditors separately for business reasons is crucial to the ability to treat all claims fairly in complex business or liability structures. Without creating separate classes for mass future claims, for example, some companies could never reorganize.[1449] To prohibit separate classification would create an unwarranted broad-based and significant change to current practices to correct a very narrow set of problems.

"Nature of Claim." Some courts have analyzed the "nature" of the claims or interests on the theory that each class must represent a voting interest that is "sufficiently distinct and weighty to merit a separate voice."[1450] According to courts that take the "nature of claim" approach, the focus of classification historically has been on the nature or legal character of the claim as it relates to the assets of the debtor.[1451] The nature of claim approach must be distinguished from the approach of courts, mandating that bank deficiency claims made recourse by operation of section 1111(b)(1)(A) be classified separately from other unsecured claims on the notion that

(4th Cir.), *cert. denied*, 506 U.S. 866 (1992). *Compare In re* Johnston, 21 F.3d 323, 327 (9th Cir. 1993) (substantial similarity is finding of fact, reviewable for clear error); s*ee In re* U.S. Truck, Co., 800 F.2d 581 (6th Cir. 1986) (distinction between claims was finding of fact); Hanson v. First Bank of South Dakota, N.A., 828 F.2d 1310, 1313 (8th Cir. 1987) (denial of motion for classification not clearly erroneous); *In re* Bloomingdale Partners, 170 B.R. 984, 997 (Bankr. N.D. Ill. 1994) (substantial similarity is "single finding of fact").

[1449] For a full discussion of this issue, refer to the recommendations on mass future claims in Section 2.1.

[1450] John Hancock Mut. Life Ins. Co. v. Rt. 37 Business Park Assoc., 987 F.2d 154 (3d Cir. 1993).

[1451] J.P. Morgan & Co. v. Missouri Pac. R.R., 85 F.2d 351 (10th Cir. 1936), *cert. denied*, 57 S. Ct. 230 (1936); *In re* Los Angeles Lumber and Invs., Ltd., 282 F. Supp. 448, 453 (D. Haw. 1968) ("word 'nature' is used in no technical sense in law but is used in its ordinary common vernacular, wherein it means kind, sort, species or character . . . . Unsecured creditors may, under special circumstances, be divided into separate classes where the legal character of their claims is such as to accord them with a status different from the other unsecured creditors"), *aff'd*, 447 F.2d 1366 (9th Cir. 1971) *citing* Scherk v. Newton, 152 F.2d 747 (10th Cir. 1945).

they are substantially dissimilar, which was the conclusion reached by the Court of Appeals for the Seventh Circuit in *Woodbrook Associates*.[1452]

The primary problem with the nature of claim approach under the Bankruptcy Code is that it does not filter out classification schemes designed only to create a class to vote favorably on the plan. Indeed, the approach inherently permits claims to be classified separately even if the debtor proposes to treat each class exactly the same. The *U.S. Truck* case provides a compelling illustration.[1453] U.S. Truck's plan segregated the Teamsters' claim for rejection of the collective bargaining agreement but provided the same treatment for that claim as the other unsecured creditors. The debtor admitted that it separately classified the other unsecured claims to ensure that it had an impaired assenting class. The Court of Appeals for the Sixth Circuit upheld the classification on the basis that the union had a different stake in the future viability of the reorganized company and had alternative means to protect its interest. The court expressly acknowledged that "to allow the Committee to vote with the other impaired creditors would be to allow it to prevent a court from considering confirmation of a plan that a significant group of creditors with similar interests have accepted."[1454] The Court of Appeals for the Fifth Circuit took a similar approach in *Heartland Federal Savings and Loan v. Briscoe Enterprises*.[1455] This housing complex debtor classified the deficiency claims of each of its undersecured mortgagees, Heartland and the city of Fort Worth, separately from the general unsecured creditors, but the plan provided the same treatment for each of these three classes. The Court of Appeals reversed the district court and affirmed the bankruptcy court's confirmation of the plan because the city of Fort Worth had a unique, distinct "non-creditor" interest in the low income housing debtor and provided $20,000 in monthly rental assistance for the tenants and mortgagee Heartland could protect its interest by nominating one of the trustees for the property.[1456] The distinct nature of

[1452] *See In re* Woodbrook Assocs., 19 F.3d 312, 318 (7th Cir. 1994), *reh'g denied* ,1994 U.S. App. Lexis 10784 (7th Cir. 1994) (significant disparities exist between legal rights of holder of section 1111(b) claim and holder of general unsecured claim that render claims not substantially similar and preclude collective classification), *citing In re* SM 104 Ltd., 160 B.R. 202, 218 (Bankr. S.D. Fla. 1993).

[1453] *In re* U.S. Truck Co., 800 F.2d 581 (6th Cir. 1986).

[1454] *Id.* at 587.

[1455] *In re* Briscoe Enterps., Ltd., II, 994 F.2d 1160 (5th Cir.), *cert. denied*, 114 S. Ct. 550 (1993).

[1456] *Id.* at 1167 (using clear error standard of review). Although the court used business justification language, the analysis directly follows the "nature of claim" line of reasoning. *See also In re* Way Apartments, D.T., 201 B.R. 444, 450 (N.D. Tex. 1996) (HUD's public interest in property justified separate classification of HUD's deficiency claim).

these interests, therefore, supported separate classification in the view of this Fifth Circuit panel.

The nature of claim analysis has been used to uphold separate classification entailing disparate treatment as well, but again with arguably questionable outcomes. For example, in *Jersey City Medical Center*, the Court of Appeals for the Third Circuit upheld separate classification and 100% payment of physicians with indemnity claims when impaired classes of prepetition medical malpractice claimants, nonpriority employee benefit claims, and general creditors, each would receive 30% of their claims. In reaching this result, the court merely said that "[w]e immediately note the reasonableness of distinguishing the claims of physicians, medical malpractice victims, employee benefit plan participants, and trade creditors."[1457]

Although the distinct nature of claims may provide a legitimate reason for different treatment in some instances, all of these cases that have used a nature of claim analysis provide insufficient guidance to subsequent courts and parties as to proper classification. This test does not necessarily screen out inappropriate separate classification for voting purposes. To permit unsecured claims to be classified separately only upon a determination that a claim has a "distinct nature" when the proponent has no business reason for separate classification perpetuates a vague and questionable standard. It requires litigation of a question that may be unrelated to the debtor's business plan, and thus wastes time and resources.

Legitimate Business Reasons. A number of courts have used or discussed a business justification standard to screen out impermissible gerrymandering of classes for voting purposes but to permit business-based classification. According to this approach, to withstand a challenge to classification of claims that are substantially similar, a proponent must demonstrate that a valid business reason supports the separate classification and treatment of groups of claims. Using this standard, the Court of Appeals for the Second Circuit upheld the proposed separate classification of unpaid workers' compensation claims from claims held by a surety in the *Chateaugay* case.[1458] Bankruptcy courts and district court cases have used a rational

[1457] *In re* Jersey City Medical Center, 817 F.2d 1055 (3d Cir. 1987) (Chapter 9 case in which all claimants retained right to recover from municipal third parties). A subsequent Third Circuit panel observed that Jersey City Medical Center provided no factors for consideration of separate classification. *See* John Hancock Mutual Life Ins. Co. v. Rt. 37 Business Park Assoc., 987 F.2d 154 (3d Cir. 1993) (looking to holdings in opinions in other circuit courts of appeals, finding that deficiency claim could not be separately classified).

[1458] *In re* Chateaugay Corp., 89 F.3d 942 (2d Cir. 1996). Chateaugay's plan guaranteed that its unpaid workers' compensation claims would be paid in full and would pay insurance company surety reimbursement claims common stock after confirmation. "[T]o warrant having separate classification of similar claims, the debtor must advance a legitimate reason supported by credible proof." *Id.* at 949, *citing In re* Boston Post Road Ltd. Partnership, 21 F.3d 477, 483 (2d Cir. 1994), business justification approach to permit separate classification when the debtor needed to put certain creditors on a different payment schedule or for other similar reasons.[1459] The Court of Appeals for the Ninth Circuit recently used a restrictive version of this test to find that non-unique trade claims could not be classified separately without business necessity, as opposed to a business justification.[1460]

Like the Ninth Circuit, many courts have indicated that the business justification test does not permit classification for the purpose of engineering an assenting impaired class.[1461] Some single asset real estate debtors have tried to

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cert. denied, 115 S. Ct. 897 (1995). Chateaugay proved that this repayment may be the employees' only wage replacement and that the distinction was justified to promote peaceful employee relations and to be able to secure sales contracts from customers. *Id.* at 949, *citing* Aff. of Vice President of Industrial Relations of LTV Steel Co. (parent of debtor). Because the treatment of Aetna's claims would not have the same impact on Chateaugay's reorganization, the bankruptcy court was found to be not clearly erroneous in determining that Chateaugay had a valid business reason for providing different treatment to its unpaid workers. The bankruptcy court also found, and the reviewing courts agreed, that classification was not designed to create an assenting impaired class. *Id.* at 950.

[1459] *See*, e.g., *In re* Georgetown Ltd. Partnership 209 B.R. 763 (Bankr. M.D. Ga. 1997) (upholding separate classification of trade creditors with continuing business relationship to be paid in shorter period of time from bank creditor with large claim that must, due to the size of its claim, be paid over longer period of time); *In re* Graphic Communications, 200 B.R. 143, 147 (Bankr. E.D. Mich. 1996) (business reason supported separate classification of debtor's business competitor from trade creditors); *In re* Richard Buick, Inc., 126 B.R. 840 (Bankr. E.D. Pa. 1991) (separate classification of dealer claims was necessary to future success of business to re-establish good relationship with dealers whose trades would supply vehicles sold); *In re* Kleigl Bros. Universal Electric Stage Lighting Co., 149 B.R. 306 (Bankr. E.D.N.Y. 1992) (lighting company permissibly segregated union's unsecured claim because debtor's ability to operate union shop is critical to ability to function successfully in industry). *See also In re* Nat'l Paper & Type Co. of Puerto Rico, 120 B.R. 624 (D.P.R. 1990) (applying clear error standard, upholding bankruptcy court determination that debtor paper company permissibly classified unsecured creditors based on size of respective claims, such that smaller claims would receive larger percentage monthly), *citing In re* Planes, Inc., 48 B.R. 698 (Bankr. N.D. Ga. 1985); *In re* Atlanta West VI., 91 B.R. 620 (Bankr. N.D. Ga. 1988).

[1460] Barakat v. The Life Ins. Co. of Virginia, 99 F.3d 1520 (9th Cir. 1996) (when "literally thousands" of similar suppliers are available, cannot separately classify and give superior treatment to trade creditors), *cert. denied*, 117 S. Ct. 1312 (1997); s*ee also In re* Ambanc La Mesa Ltd. Partnership, 115 F.3d 650, 657 (9th Cir. 1997) ("continued services of ordinary tradespeople may not always be a commercial necessity for an apartment operator in a large metropolitan area with many other providers of those services").

[1461] *See, e.g.*, Barakat v. The Life Ins. Co. of Virginia, 99 F.3d 1520 (9th Cir. 1996) (obtaining impaired accepting class does not constitute legitimate business or economic reason), *cert. denied*, 117 S. Ct. 1312 (1992); *In re* Boston Post Road Ltd. Partnership, 21 F.3d 477 (2d Cir. 1994) (proponent unable to offer proof of business justification for separate classification of FDIC), *cert. denied*, 115 S. Ct. 897 (1995); Lumber Exchange Building Ltd. Partnership v. Mutual Life Ins. Co. of New York, 968 F.2d 647 (8th Cir. 1992) (debtor unable to proffer legitimate reason for separately classifying deficiency claim; *In re* Bryson Properties, XVIII, 961 F.2d 496, 502 (4th Cir. 1992) demonstrate a legitimate business reason, but the facts of the case have destined them for failure. In *Greystone*, the debtor argued it had separately classified the mortgagee's deficiency claim for business reasons relating to its need to maintain good will among its trade creditors that otherwise would stop engaging in business and would injure the debtor's reputation.[1462] Rejecting this contention, the Court of Appeals for the Fifth Circuit noted that "Greystone's justification for separate classification of the trade claims might be valid if the trade creditors were to receive different treatment from Phoenix," but because Greystone was not proposing that the trade creditors be treated any differently than the deficiency claim, the court rejected Greystone's "realities of business" argument.[1463]

Similarly, in *Lumber Exchange*, the debtor argued that separate classification of the mortgagee's deficiency claim was warranted because "secured creditors look to different assets for repayment than do unsecured creditors and because the maintenance of good business relationships is important to a debtor's ongoing business." The Eighth Circuit acknowledged the existence of "some authority for the proposition that a plan may classify trade creditors separately from, and treat them more generously than, other creditors if doing so is necessary to a debtor's ongoing business. [citations omitted] The integrity of *Lumber Exchange*'s argument, however, is belied here by the plan's own terms. The proposed plan treats trade creditors less generously, not more. Accordingly, we conclude that this proffered justification for separate classification is not legitimate."[1464] Courts have been able to distinguish

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("where all unsecured claims receive the same treatment in terms of the Plan distribution, separate classification on the basis of natural and unnatural recourse claims is, at a minimum, highly suspect," and requires further justification), *cert. denied*, 506 U.S. 866; *In re* Greystone III Joint Venture, 948 F.2d 134, 141 (5th Cir. 1991) (debtor unable to provide legitimate reason or sufficient legal distinction to justify separate classification of deficiency claim), *cert. denied*, 113 S. Ct. 72 (1992); *In re* Hillside Park Apts, 205 B.R. 177 (Bankr. W.D. Mo. 1997) (debtor provided no good business reason or justification for separately classifying creditor's deficiency claim from claims of general unsecured creditors).

[1462] *In re* Greystone III Joint Venture, 948 F.2d 134, 141 (5th Cir. 1991), *cert. denied*, 113 S. Ct. 72 (1992).

[1463] *Id.* at 141-142. For a discussion of the significance of "business realities" for classification under the Bankruptcy Act of 1898, s*ee In re* LeBlanc, 622 F.2d 872, 879 (5th Cir. 1980) ("[T]rade creditors advanced goods and services to the debtor in the ordinary course of business, frequently without any knowledge of the debtor's financially perilous condition and without any real opportunity to protect themselves. Furthermore, the proponents of the plan who were to operate the hotel under the plan may well have needed to maintain good relations with trade creditors upon whom they would have to rely to furnish additional goods and services to the hotel. In contrast, the insiders made loans to the debtor when they were in a position to know of the debtor's financial condition and the risks involved with those loans. Also, the insiders were not going to have any ongoing relationship with the hotel after confirmation of the plan").

[1464] *In re* Lumber Exchange Building Ltd Partnership, 968 F.2d 647, 649 (8th Cir. 1992);

those cases in which legitimate business reasons exist from those in which separate classification is merely a thinly-veiled attempt to create an accepting class of creditors as required by section 1129(a)(10) for confirmation.

The Commission's Recommendation endorses the rational business justification approach. It protects creditors' interests while it preserves reasonable flexibility to structure a plan of reorganization to meet the business needs of the parties in interest and facilitate the reorganization efforts of all parties in the vast majority of cases. The test requires business justification, not business necessity. A proponent could treat similar claims differentially, but, as the case law reveals, a court could *not* uphold a classification scheme when the only benefit to the proponent would be the creation of an assenting class for voting purposes, nor could it uphold such a scheme upon objection in the absence of persuasive evidence that the differential treatment is justified by the business needs.

However, classification for business purposes is an important feature of Chapter 11 plans and in most cases is perfectly legitimate. A plan proponent might request separate classification and disparate treatment of creditors for rational business purposes in a number of instances. Among the examples:

> A creditor advocates a plan in which a substantial proportion of the creditors would receive stock as part of their payout to prevent the business from being strapped for cash. Some of its creditors prefer to receive stock or are willing to accept either cash or stock. Legal restrictions may prevent certain creditors, such as government agencies, from taking stock. Other creditors, such as individuals, may not be in an economic position to receive repayment in stock. The creditor's plan might propose two groups: a cash payment group and a stock-and-cash payment group.
>
> A business intends to pay all unsecured creditors 50%. The small trade creditors cannot afford to wait for repayment and the debtor wants to maintain business relations with these creditors, so the plan proposes to pay them 50% in cash at confirmation. The large bank creditors would receive 50% over three years at prevailing market interest rates.
>
> A company failed to make required retirement plan contributions in the months before bankruptcy. Concerned about the negative impact on the work force, the company proposes to pay the retirement

see also In re Bryson Properties, XVIII, 961 F.2d 496, 502 (4th Cir.) (debtor unable to justify separate classification of natural and section 1111(b) recourse claims when debtor was proposing identical treatment), *cert. denied*, 506 U.S. 866 (1992).

> arrearage in excess of the wage priority claims in cash at plan confirmation. Other commercial debt holders would be paid in full over four years with market interest.
>
> A creditor group plans to take over a business that is in bankruptcy and wants to keep business relations with the suppliers that currently are doing business with the company. In its plan, the group proposes to pay 50% of the trade debt doing business with the company over 90 days, and to pay a similar percentage of the bank debt, with interest, over two years.

As the preceding examples demonstrate, separate classification based on rational business justification gives a plan proponent—debtor or creditor—the flexibility to propose a plan that is tailored to meet the business needs of the reorganized debtor while seeking to maintain some equivalence of value distributed to classes.[1465]

The Commission's Recommendation to permit separate classification based on rational business justification would implement a test already being used by many courts. No standard will completely eliminate all classification controversies because classification of claims always will entail some court supervision. The key is to choose a standard that is sensible and that accomplishes the goals of precluding classification solely for voting purposes and permitting classification for business purposes. The prescribed business-oriented approach to section 1122 capitalizes on the specialized expertise of the bankruptcy courts that are routinely called on to evaluate business options and rule on business questions. The court's inquiry would be focused on factors at the heart of the reorganization, not on a searching legal and philosophical analysis of the distinctions among types of claims. If section 1122 precluded separate classification of substantially similar claims, parties would find numerous occasions for litigating the legal or substantial similarity of claims, which is not relevant to the bankruptcy case and thus increases unnecessary costs. The Commission endorsed the "business justification" test not only because it will minimize litigation over the threshold substantial similarity question, thereby reducing cost and delay, but also because it more properly will focus the litigated inquiry on the business needs of the reorganizing company rather than concentrating on the legal attributes of a few creditors. In addition, because most courts already have determined that "rational business justification" is a fact-based inquiry that invokes a clear error standard, the appellate process will not be unduly burdened.[1466]

[1465] *See In re* Eddington Thread Mfg. Co., 181 B.R. 826, 834 (Bankr. E.D. Pa.) (future cash shortfall warranted separate classification of creditors agreeing to deferred payments), *appeal dismissed*, 189 B.R. 898 (E.D. Pa. 1995).

[1466] *See In re* Chateaugay Corp., 89 F.3d 942, 950 (2d Cir. 1996) ("no reason to suppose that proffered business reasons were legitimate was clearly erroneous"); *In re* Greystone III Joint Venture, *Disallowance of Significant Disparities between Consenting and Dissenting Classes - The Unfair Discrimination Prohibition in Section 1129(b)*. A nonconsensual plan cannot be confirmed merely because a plan proponent obtained the requisite votes from the classes it constructed. The Code imposes strict legal requirements and provides a variety of bases on which creditors can object, both individually and by class. Thus, any proposed plan must meet all of the requirements of sections 1123(a) and 1129(a), which includes obtaining the votes of the requisite majorities of the classes to have a consensual plan confirmed by the court.

If a single impaired class votes against the plan and the proponent seeks cramdown, the plan must satisfy section 1129(b) as well. A creditor that holds a claim in a dissenting class could raise a section 1129(b)(1) "unfair discrimination" objection based on treatment that is markedly different than other classes of similar priority. Unfair discrimination, not classification, is the appropriate vehicle to challenge the inherent unfairness of a plan.[1467] Courts take this requirement very seriously and consider it at nonconsensual confirmation hearings.[1468] At that point, courts can assess whether the distinctions in treatment among the classes amount to unfair discrimination against a dissenting class, thereby rendering the plan unconfirmable.[1469] The Code prohibits unfair discrimination of a dissenting class as

948 F. 2d 134, 141 (5th Cir. 1991) (whether there were good business reasons to support debtor's separate classification of claims is question of fact), *cert. denied*, 113 S. Ct. 72 (1992); Bustop Shelters of Louisville, Inc. v. Classic Homes, Inc., 914 F.2d 810, 812 (6th Cir. 1990) (courts have discretion to determine proper classification under factual circumstances, reviewable for clear error only).

[1467] *In re* City of Colorado Springs, 187 B.R. 683, 689 (Bankr. D. Col. 1995) (improper treatment of classes is addressed in "unfair discrimination analysis" of section 1129(b)); *In re* ZRM-Oklahoma Partnership, 156 B.R. 67, 70-71 (Bankr. W.D. Okl. 1993) (section 1129(b) prohibition on unfair discrimination, section 1129(a)(3) good faith requirement, section 1129(a)(7) best interest test, and section 1111(b) election adequately address improper treatment).

[1468] *See, e.g., In re* Graphic Communications, Inc., 200 B.R. 143 (Bankr. E.D. Mich. 1996) (paying one class 100% while paying another class 10% is unfair discrimination); Piedmont Assocs. v. Cigna Property & Casualty Ins., 132 B.R. 75, 78 (N.D. Ga. 1991) (distinctions in size and nature of debt not valid business reasons for separate classification; proposed treatment unfairly discriminated). *See also* Barnes v. Whelan, 689 F.2d 193, 201 (D.C. Cir. 1982) (separately classifying cosigned debts permissible under 1122, 1322, but plan unfairly discriminated).

[1469] *In re* Aztec Co., 107 B.R. 585, 592 (Bankr. M.D. Tenn. 1989) (basis for separate classification does not predetermine whether treatment of separate classes under plan is fair discrimination for purposes of section 1129(b)(I)). *See also* REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 29 (rev. ed. 1997) recommending Proposal endorsed by Commission and disapproving of "view that substantial disparity in treatment is not invariably unfair discrimination").

compared to other classes with similar classes that may have accepted the plan.[1470] To evaluate unfair discrimination, some courts use a multifactor test, considering: 1) whether the discrimination is supported by a reasonable basis; 2) the debtor could not confirm or consummate the plan of reorganization without the discrimination; 3) the discrimination is proposed in good faith; and 4) the degree of discrimination is related to the basis or rationale for the discrimination.[1471] Other courts do not use an explicit multi-factor test, but subject any discrimination among similar classes to close scrutiny.[1472] An unfair discrimination test should prevent significantly disparate treatment of different dissenting classes of creditors that have similar legal priority, but would not preclude distinctions in the methods of payment that ultimately resulted in similar treatment.[1473]

Corollary Point on Section 1129(a)(10). Although the Commission is not recommending any changes to section 1129(a)(10), the root of the improper classification debates is this provision, which requires that at least one impaired class of claims accept the plan, excluding acceptances of insiders.[1474] Some have argued

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[1470] Corestates Bankr, N.A. v. United Chemical Tech., Inc. 202 B.R. 33, 47 (E.D. Pa. 1996), *citing* H.R.REP. NO. 95-595, at 417 (1977).

[1471] *In re* Ambanc La Mesa Ltd. Partnership, 115 F.3d 650 (9th Cir. 1997); *see also In re* 11,111, Inc., 117 B.R. 471, 478 (Bankr. D. Minn. 1990); *In re* Eitemiller, 149 B.R. 626 (Bankr. D. Idaho 1993) (applying test with slight variation).

[1472] *See, e.g.,* 201 N. LaSalle Partnership, 190 B.R. 567 (Bankr. N.D. Ill. 1995), *aff'*d, 195 B.R. 692 (N.D. Ill. 1996), *aff'd*, Nos. 96-2137, 96-2138 slip op., 1997 WL 602640 (7th Cir. Sept. 29, 1997); *In re* Barney and Carey Co., 170 B.R. 17, 25 (Bankr. D. Mass. 1994) (even if totally separate classification . . . were permissible, the unfair discrimination language prohibits a debtor from proposing unreasonably different treatment between classes of similar claims. In other words, regardless of classification, the similarly situated claims of unsecured creditors and the deficiency claims of the mortgage holders must not be treated in such a disparate manner as to be unfair.").

[1473] *See In re* Martin, 66 B.R. 921, 929 (Bankr. D. Mont. 1986) (plan protecting legal rights of dissenting class in manner consistent with treatment of other classes does not discriminate unfairly with respect to dissenting class).

[1474] 11 U.S.C. § 1129(a)(10) (1994) provides "[i]f a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by an insider." Section 1129(a)(10) was enacted as a last minute reaction to a single asset real estate case under Chapter XII of the Bankruptcy Act of 1898 in which the court confirmed a plan that was supported by no classes of materially and adversely affected creditors. *In re* Duval Manor Assocs., 191 B.R. 622, 628 (Bankr. E.D. Pa. 1996) ("It is widely known that the requirement was designed to ameliorate a perceived harshness inherent in the cramdown provisions available under the Code in the wake of the decision in *In re* Pine Gate Associates"); *In re* Pine Gate Associates, 2 Bankr. Ct. Dec. 1478 (N.D. Ga. 1976). Originally, it was not clear if the accepting class of creditors had to be impaired. *See In re* Victory Constr. Co., 42 B.R. 145, 152 (Bankr. C.D. Cal. 1984) (discussing case law split and absurdities of various interpretations of provision). To settle this debate, Congress amended the provision in the that eliminating section 1129(a)(10), the underlying cause of strategic classification, would be the most expedient way to resolve the classification disputes.[1475] This view is premised on the notion that section 1129(a)(10) is not necessary for creditor protection, and in fact, frequently exacerbates competing interests among creditors.[1476] Because treatment that is neither materially different nor adverse can render classes of claims impaired,[1477] some courts have held that section 1129(a)(10) can be satisfied by the affirmative votes of classes that receive a full distribution 30 days after plan confirmation,[1478] that are paid all but $75 of their claims,[1479] and, at least in the Ninth Circuit, that receive *enhanced* treatment under the plan.[1480] In most reorganization

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Bankruptcy Amendments and Federal Judgeship Act of 1984 to clarify that if a plan impaired a class of claims, the plan had to be approved by a class of *impaired* claims. *See In re* Sun Country Dev., 764 F.2d 406, 408 n. 3 (5th Cir. 1985) (because section 1129(a)(10) was clarified, court need not consider whether unimpaired accepting class would have satisfied provision).

[1475] *See*, e.g, Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Chapter 11 Process*, 69 Am. Bankr. L. J. 551 (1995).

[1476] *See* Nicholas L. Georgakopoulos, *New Value, Fresh Start*, 3 STAN. J. L. BUS. & FIN, n.78 (1997) (discussing how section 1129(a)(10) induces groups of creditors to sell each other out by accepting higher payments to be impaired accepting class while other classes get crammed down).

[1477] *See* L&J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc., 995 F.2d 940 (9th Cir. 1993) (improvement of position can be impairment); "Impairment under section 1124 has generally come to mean in its most basic form any alteration of the holder's legal, equitable, or contractual rights, unless payment in cash of the allowed amount of the claim is made on the effective date of the plan." *In re* Block Shim Dev. Co., 118 B.R. 450, 454 (N.D. Tex. 1990) (interpreting pre-1994 impairment definition), *aff'd*, 939 F.2d 289 (5th Cir. 1990). This is a marked change from section 107 of the Bankruptcy Act of 1898, which provided that "creditors" or "any class thereof" was "affected" for purposes of a plan "only if their or its interest shall be materially and adversely affected thereby." 11 U.S.C. § 507 (repealed 1979).

[1478] *In re* Hotel Assoc. of Tucson, 165 B.R. 470, 475 (B.A.P. 9th Cir. 1994)(rejecting creditor's argument that debtor "artificially" impaired class by delaying payment 30 days when debtor had cash to pay class on effective date).

[1479] *See In re* Witt, 60 B.R. 556 (Bankr. N.D. Iowa 1986).

[1480] L&J Anaheim Assocs. v. Kawasaki Leasing Int'l, Inc., 995 F.2d 940 (9th Cir. 1993). In addition, Congress removed subsection (3) of section 1124 (the provision that determines which classes of creditors are unimpaired) so that classes of fully-paid creditors, whose only harm from the bankruptcy case is lack of postpetition interest, are impaired. Some have perceived this change to be a "functional repeal" of section 1129(a)(10) because of such creditors are likely to support the plan. Linda J. Rusch, *Unintended Consequences of Unthinking Tinkering: The 1994 Amendment and the Chapter 11 Process*," 69 AM. BANKR. L. J. 349, 392 (1995); *In re* Atlanta Stewart Partners, 193 B.R. 79, 82 (Bankr. N.D. Ga. 1996) (section 1124 amendment should minimize litigation over section 1129(a)(10)); David Gray Carlson, *Rake's Progress: Cure and Reinstatement of Secured Claims in Bankruptcy Reorganization*, 13 BANKR. DEV. J. 273 (1997) ("virtually any change in rights proves that a plan does not leave creditor rights unaltered. Thus, a change in the maturity date cases, holders in impaired classes receiving this type of treatment will be reasonably satisfied and will vote in favor of the plan.[1481]

However, creditors seeking to block plan confirmation have sought to read additional constraints into section 1129(a)(10) beyond what the plain language of the statute provides. They argue that the treatment of some classes has been altered "artificially" or that the plan proponent classified claims improperly to construct an impaired accepting class, thereby violating section 1129(a)(10), even though that section does not address the composition of the impaired class. These issues have provoked a tremendous amount of litigation.[1482]

Sympathetic to these concerns, some courts decline to read section 1129(a)(10) literally. According to the Court of Appeals for the Eighth Circuit and courts that have followed its lead, a class of claims can be "impaired" under section 1124 but "unimpaired" for purposes of section 1129(a)(10) if the alteration of rights arises from the plan proponent's exercise of discretion.[1483] This approach, which has been somewhat popular in single asset real estate cases, potentially gives a secured creditor "veto power" over plan confirmation in the case of a debtor notwithstanding the affirmative vote of an impaired class of creditors.[1484] Under this method of analysis, a court not only substitutes its judgment for that of the claim holders who

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or a substitution of debtors or collateral is an impairment, even if the collateral is better in quality and more in quantity. Lump sum payment in lieu of installments is likewise an impairment. By some accounts, even an improvement in position is an impairment").

[1481] "Impairment, for the most part, is not a device to permit or justify the alteration of rights. It is a measuring rod to determine who may vote, dissent, and invoke the protection of Section 1129(b)." *In re* Barrington Oaks General Partnership ,15 B.R. 952, 959 n.19 (Bankr. D. Utah 1981) (explaining Chapter 11 plan negotiation under Bankruptcy Code of 1978).

[1482] *See generally* David Gray Carlson, *The Classification Veto in Single-Asset Cases under Bankruptcy Code Section 1129(a)(10),* 44 S.C.L. REV. 565 (1993).

[1483] Windsor on the River Assocs. Ltd. v. Balcor Real Estate Fin., Inc., 7 F.3d 127 (8th Cir. 1993); *In re* W.C. Peeler Co. Inc, 182 B.R. 435 (Bankr. D.S.C. 1995) (because debtor could have paid impaired accepting class sooner out of income, class not truly impaired and plan not confirmable); *In re* Investors Fla. Aggressive Growth Fund Ltd., 168 B.R. 760, 766 (Bankr. N.D. Fla. 1994) (paying unsecured trade debt in four installments when debtor had other unencumbered assets is not true impairment for purposes of section 1129(a)(10), thus plan not confirmable); *In re* North Washington Center Ltd. Partnership, 165 B.R. 805, 810 (Bankr. D. Md. 1994) (paying accepting trade creditors 80% when court believed that debtor could have paid 100% meant that trade creditors were not actually impaired).

[1484] David Gray Carlson, *The Classification Veto in Single-Asset Cases under Bankruptcy Code Section 1129(a)(10)*, 44 S.C.L.REV. 565, 614 (1993) ("nowhere is it written that a debtor-in-possession has a duty to maximize the opportunity for one single creditor to veto the proceedings").

voted affirmatively on the plan, but the court also speculates on alternative methods of restructuring the debtor that would unimpair various classes of creditors.

Other courts have been critical of this approach.[1485] These courts have reasoned that the Code "literally allows any impairment to qualify, and does not specify a degree of impairment in terms of the magnitude of the impairment or of the claim. Where there is no ambiguity in the statute, federal courts normally will not interpose equitable qualifications that the legislature has not explicitly put in the statute."[1486] This interpretation comports with the Supreme Court's mandate that courts should read the Bankruptcy Code literally and not impose their own gloss on clear statutory language.[1487] These courts also have reasoned that other confirmation requirements offer creditors both procedural and substantive protection to ensure fair treatment of dissenting classes, particularly in the context of a nonconsensual plan.[1488] This reading is bolstered by the fact that the Chapter 11 confirmation process protects individual creditor interests as well: all plans must have been proposed in good faith and must provide each individual impaired and dissenting creditor with at least as much as they would have received in a Chapter 7 liquidation.[1489]

[1485] "We do not believe it is the bankruptcy court's role to ask whether alternative payment structures could produce a different scenario in regard to impairment of classes. Denying confirmation on the basis that another type of plan would produce different results would impede desired flexibility for plan proponents and create additional complications in the already complex process of plan confirmation." *In re* Hotel Assoc. of Tucson, 165 B.R. 470, 475 (B.A.P. 9th Cir. 1994).

[1486] *In re* Beauchesne, 209 B.R. 266, 275 (Bankr. D. N.H. 1997). *See* also *In re* L&J Anaheim Assocs., 995 F.2d 940 (9th Cir. 1993) (any alteration of rights, including abrogation of secured creditor's rights and remedies under Uniform Commercial Code, is impairment); *In re* Beare Company, 177 B.R. 886, 889 (Bankr. W.D. Tenn. 1994) (section 1129(a)(10) satisfied by acceptance by class impaired by delay in payment for 60 -120 days); *In re* 7th Street & Beardsley Partnership, 181 B.R. 426, 431 (Bankr. D. Ariz. 1994) ("Section 1129(a)(10) is a technical requirement for confirmation. It is an obligation for the proponent of a Plan to fulfill; it is not a substantive right of objecting creditors").

[1487] United States v. Ron Pair Enter. Inc., 489 U.S. 235 (1989).

[1488] *See*, e.g., *In re* Beauchesne, 209 B.R. 266, 275 n.14 (Bankr. D. N.H. 1997) ("application of the absolute priority rule is the real protection for the secured creditor, rather than reading "artificial impairment" or a minimal impairment requirement into section 1129(a)(10)"); *see also* Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551, 569 n.96 (1995) (describing other Code tools to protect creditors, including appointment of examiner (section 1104), curtailment of business operations (section 1108), conversion or dismissal (section 1112), or termination of exclusivity (section 1121)).

[1489] 11 U.S.C. § 1129(a)(3), (a)(7) (1997).

To reduce cost and delay and to permit parties to focus on the substantive issues in the plan, the Commission's Chapter 11 Working Group recommended the repeal of section 1129(a)(10), as has been advocated by some individuals and groups.[1490] The Commission did not endorse this Proposal, and therefore clarification of classification standards remains the Commission's recommended approach to resolving this issue.

Special Problems of Single Asset Real Estate Cases. The proposed approach to classification is intended to address the classification problems in single asset real estate cases without skewing the law for the other types of cases. Single asset real estate cases have been credited as the cause of the enactment of section 1129(a)(10) and the source of much of the claims classification debate. Because of broader concerns about the utility of the bankruptcy process for single asset real estate cases, Congress has amended the Bankruptcy Code to give more rights to secured creditors of single asset real estate ventures.[1491] Following this lead, the Small Business, Partnership and Single Asset Real Estate Working Group of the Commission concluded that single asset cases should be subject to different rules of cramdown in plan confirmation.

Whether or not single asset real estate cases continue to be candidates for Chapter 11 on an equal footing with other businesses, other existing Bankruptcy Code provisions can expedite resolution of single asset cases. Creditors can seek relief from the stay. In addition, the Code currently provides single asset mortgage lenders with additional grounds for speedier relief.[1492] Courts also have relatively wide latitude to dismiss cases under sections 305 or 1112. The efficacy of soundly-drawn generic rules to deal with a wide range of circumstances should not be underestimated.

[1490] REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT 27 (rev. ed. 1997); Kenneth N. Klee, *Adjusting Chapter 11: Fine-Tuning the Plan Process*, 69 Am. Bankr. L. J. 551, 568 (1995); Letter from C. Daniel Motsinger to Elizabeth Warren, Reporter, regarding informal poll of approximately 25 attorneys from Indiana, Minnesota, Georgia, Colorado, and California (July 17, 1997) (substantial sentiment to repeal section 1129(a)(10) with a minority of lawyers arguing that section 1129(a)(10) encourages consensus building); John R. Clemency & John A. Harris, *The Fight Over 'Artificial Impairment' Under Section 1129(a)(10): It's Time to Call it Quits*, 14 AM. BANKR. INST. J. 20, 23 n.10 (1995); Gregory K. Jones, *The Classification and Cramdown Controversy in Single Asset Bankruptcy Cases: A Need for the Repeal of Bankruptcy Code Section 1129(a)(10)*, 42 UCLA L. REV. 623 (1994) (classification problems and concomitant litigation and inconsistent holdings, could be largely resolved if section 1129(a)(10) were repealed in single asset cases).

[1491] Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106, and Bankruptcy Amendments of 1997, H.R. 724, 105th Cong. (1997).

[1492] 11 U.S.C. § 362(d)(3) (1994) (court shall grant relief from stay of act against single asset real estate debtor by secured creditor unless debtor has filed plan of reorganization or commenced monthly payments to creditor within 90 days after entry of order for relief).

However, as courts and legislators continue to address single asset cases in addition to the broad range of businesses and liability structures that attempt reorganization under Chapter 11, no single type of case should have a disproportionate impact on statutory rules and case decisions governing all other cases.

Competing Considerations. This Proposal does not resolve all classification questions because it does not address what claims are substantially similar. Because substantial similarity is inherently a fact-intensive issue, a more specific definition of legal or substantial similarity would be inappropriate and inadequate due to the almost infinite number of factual distinctions that may arise. However, the Proposal would ameliorate some of confusion stemming from the nature of claim analysis, thus making the overall approach clearer and eliminating some intermediate litigation.

Some might be concerned that this Proposal would encourage plan proponents to discriminate among creditors. The Commission does not intend to endorse significant distinctions in treatment among creditors with similar legal rights and is confident that the unfair discrimination prohibition in section 1129 precludes inappropriate distinctions. However, the unfair discrimination test does not protect a single dissenting creditor in a consensual plan when that creditor has been outvoted by its fellow class members. Some observers who are leery about court discretion might find that these mechanisms offer insufficient protection. Even those observers should recognize, however, that by imposing a single standard to be used by all courts, the Proposal increases protection significantly for creditors appearing in the courts that presently use more flexible standards.

2.4.17 *Prepetition Solicitation for a Prepackaged Plan of Reorganization*

The standards and requirements provided in the Bankruptcy Code for postpetition solicitation should be applicable to solicitation for a plan of reorganization within 120 days prior to filing a Chapter 11 petition by an entity that is subject to and in compliance with the public periodic reporting requirements of the Securities Exchange Act of 1934. Notice of such prepetition solicitation should be served on the Securities and Exchange Commission. If an entity solicits for a plan of reorganization but does not file for bankruptcy, the bankruptcy requirements and standards should be applicable if an entity does not complete an exchange offer or any other transaction on the basis of such solicitation.

An oft-cited goal of Chapter 11 is to encourage swift and successful reorganizations with lower transaction costs.[1493] Prepackaged Chapter 11 plans

[1493] *See, e.g.,* James J. White, The Virtue of Speed in Bankruptcy Proceedings, Statement before the National Bankruptcy Review Commission 6 (May 14, 1997) (concluding that "speed is an antidote to many of the substantive ills in Chapter 11. That speed will benefit not only secured promote this goal. While they have become more well-known in the 1990s, the prepackaged bankruptcy concept far pre-dates the enactment of the Bankruptcy Code in 1978.[1494] As discussed in the first part of this section, a prepack can have significant advantages over both a traditional Chapter 11 and a restructuring that takes place fully out of court. A prepack allows a business to conduct the negotiations outside of bankruptcy to minimize disruption and costs to all parties that are often associated with a protracted Chapter 11 process.[1495] At the same time, a prepack permits a business to reach an arrangement that satisfies the majority of creditors, and then file for bankruptcy to effectuate and implement that agreement, minimizing the leverage of minority groups of creditors that would hold out and prevent a workout outside of bankruptcy. A prepack may be most appropriate for an entity that has to adjust its debt structure but does not need to repair operational problems with the extensive use of tools found in bankruptcy. Likewise, a prepack can be a preferable option for a transnational company to prevent creditors outside the United States from seizing assets or for a company that has a strong incentive to minimize the time it actually spends under the protection of the bankruptcy court. Given the advantages, it is not surprising that prepackaged plans of reorganization constitute a significant percentage of the bankruptcies filed by publicly held corporations.[1496]

The Commission's recommendations to clarify certain legal points and the confirmation standards would further enable parties to streamline and lower the costs of Chapter 11 cases through prepackaged plans of reorganization. However, the prepack process itself could use several narrow changes to increase the likelihood that companies could reorganize using a prepack instead of a traditional Chapter 11 case. A business' ability to solicit votes for a plan of reorganization prepetition is the key factor to a prepack. If this process is more complicated and costly than the slower and conventional route, businesses are less likely to choose the prepack route.

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creditors, but unsecured creditors as well,"); *accord* Neal Batson & Matthew W. Levin, Prepackaged and Pre-Negotiated Plans of Reorganization, submitted in connection with New York University School of Law 21st Annual Workshop on Bankruptcy and Business Organizations (1995) ("[a] prepackaged or pre-negotiated bankruptcy plan may avoid some of the delay and expense inherent in the more typical Chapter 11 bankruptcy process").

[1494] In equity receivership proceedings in the late nineteenth century, a committee of bondholders or creditors would solicit bonds, structure a reorganization plan, and seek court confirmation in an expedited proceeding.

[1495] *See* Memorandum from Jay M. Goffman regarding proposed amendments to the Bankruptcy Code and Securities Laws relating to prepackaged bankruptcy cases (June 12, 1997) (describing prepack procedure and recommending methods to improve process and reduce costs).

[1496] *See* Stuart C. Gilson, *Investing in Distressed Situations; A Market Survey*, 51 FIN. ANALYSTS J. 8 (1995) (approximately one in four public company bankruptcy filings since 1989 were prepackaged); 1997 BANKRUPTCY YEARBOOK & ALMANAC (over 20% of publicly held companies filed in 1993 were filed and completed as prepacks).

Like any solicitation outside of bankruptcy, a fundamental component of soliciting votes on a Chapter 11 plan of reorganization is providing sufficient disclosure to the voters on the implications of the plan to make an informed determination. However, there are significant differences between soliciting on a Chapter 11 plan and soliciting outside of bankruptcy. Congress specifically contemplated that solicitation and disclosure for a Chapter 11 plan of reorganization warrant their own procedural requirements and a flexible standard of "adequate disclosure" that will depend on the condition of both the debtor and the debtor's books and records.[1497] Moreover, the types of information that help a creditor or shareholder in choosing whether to support a plan of reorganization do not always overlap with information that is required to be disclosed to a potential investor of a financially healthy company. The Bankruptcy Code therefore requires a disclosure statement in place of a prospectus or proxy statement and employs an "adequate information" requirement as defined in section 1125(a).[1498] This standard and the bankruptcy solicitation and disclosure requirements preempt otherwise applicable nonbankruptcy standards for a business in a traditional Chapter 11.[1499] Thus, under current law, Chapter 11 debtors that properly solicit votes on a plan of reorganization are not subject to securities laws and regulations governing solicitation of acceptance or rejection of a plan or the offer, issuance, sale, or purchase of securities; they are exempt from the registration and disclosure requirements and protected from strict liability under section 5 of the 1933 Act.[1500] This permits the court to evaluate whether the proposed disclosure is appropriate under the circumstances.

[1497] S. REP. NO. 95- 989, at 120 (1978), H.R. REP. NO. 95-595, at 408 (1977) ("Reporting and audit standards devised for solvent and continuing businesses do not necessarily fit a debtor in reorganization. Subsection (a)(1) expressly incorporates consideration of the nature and history of the debtor and the condition of its books and records into the determination of what is reasonably practicable to supply"). These factors are particularly pertinent to historical data and to discontinued operations of no future relevance. *See generally* Stephen H. Case & Mitchell A. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations*, 1991 SURV. OF AM. L. 75, 105.

[1498] Section 1125(a)(1) provides that "'adequate information' means information of a kind, and in sufficient detail as far as is reasonably practical in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan." 11 U.S.C. § 1125(a)(1) (1994).

[1499] *See* 11 U.S.C. § 1125(d) (1994).

[1500] 11 U.S.C. § 1145(a) (1994) (establishing that section 5 of the 1933 Act and parallel state laws do not apply to offer of security of debtor); *id.* at § 1125(d) (exempting disclosure statements from securities law requirements); *id.* § 1125(e) (to effectuate subsection (d), precluding liability for anti-fraud provisions relating to disclosure requirements).

Debtors are permitted to solicit prepetition for a plan of reorganization in the attempt to formulate a prepackaged plan. However, while the disclosure needs for Chapter 11 plan solicitations are the same prepetition and postpetition, these prepetition solicitations are subject to nonbankruptcy requirements because prepetition solicitation for a plan is not included in the bankruptcy exemption from the securities law registration and disclosure requirements,[1501] nor does it always fit an exemption under the securities laws themselves.[1502] Thus, a corporation soliciting votes for a plan prepetition currently must comply with applicable registration and disclosure requirements under the Securities Act of 1933, the Securities Exchange Act of 1934, and state securities and blue sky laws rather than the somewhat different standards of the Bankruptcy Code.[1503]

The bankruptcy system imposes additional restraints on prepetition solicitation, which, if not satisfied, can result in invalidation of votes and the need to re-disclose and re-solicit.[1504] Some of the types of information essential for adequate disclosure for bankruptcy purposes are not elicited on certain standard forms under the securities laws, such as information about claims against the debtor's estate, a Chapter 7 liquidation analysis, or an estimate of administrative expenses. Thus,

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[1501] Section 1145(a) only applies to offers of securities of the *debtor*, defined in the Code as a party "concerning which a case under this title has been *commenced*." 11 U.S.C. § 101(13) (1994) (emphasis added). Section 1125 appears to protect only postpetition disclosure, although some commentators do not agree with this interpretation. *See*, *e.g.*, Stephen H. Case & Mitchell A. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations*, 1991 SURV. AM. L. 75, 184.

[1502] *See*, *e.g.*, Securities Act of 1933, § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1997) (exempting certain exchange offers from Section 5 registration requirements if new security is issued by same entity that issued old security and offered to existing security holders with no payment to professionals for solicitation of exchanges); *id.* at § 4(2), 15 U.S.C. § 77d(2) (exempting private exchanges).

[1503] *See* 11 U.S.C. § 1126(b) (1994) (prepetition solicitations valid only if in accordance with applicable nonbankruptcy law). *See* Neal Batson & Matthew W. Levin, Prepackaged and Pre-Negotiated Plans of Reorganization, submitted in connection with New York University School of Law 21st Annual Workshop on Bankruptcy and Business Organizations, 904 (1995) ("biggest disadvantage of the prepackaged plan process . . . is that the debtor may need to comply with two separate sets of disclosure laws relative to its prepackaged plan: nonbankruptcy law and bankruptcy law. . . nonbankruptcy disclosure requirements oftentimes can be exceedingly arcane and complex.").

[1504] Rule 3018(b) provides that "[A] holder [of record] of a claim or interest who has accepted or rejected a plan before the commencement of the case under the Code shall not be deemed to have accepted or rejected the plan if the court finds after notice and hearing that the plan was not transmitted to substantially all creditors and equity security holders of the same class, that an unreasonably short time was prescribed for such creditors and equity security holders to accept or reject the plan, or that the solicitation was not in compliance with section 1126(b) of the Code."

prepetition solicitation activity must comply with conflicting and cumbersome sets of standards and procedural requirements.

The lack of an exemption for prepetition solicitation can be a significant impediment, which might lead a debtor to initiate a traditional Chapter 11 case instead, or to pursue a "pre-negotiated" plan in which most of the negotiation—but not the solicitation—takes place prior to filing. For a company that is a prime candidate for a prepack, this results in a longer stay in bankruptcy than otherwise would be necessary, along with the correlative increased costs of administration,[1505] disruption to business practice, and decrease in public confidence.

The Commission recommends that the Bankruptcy Code disclosure requirements, which were designed with a financially-troubled company in mind, be available for application to pre-filing solicitations in lieu of otherwise applicable requirements. In so doing, the Proposal would eliminate the dual-track governance of disclosure for prepackaged Chapter 11 plans of reorganization and would provide a clear set of rules and standards for prepacks if the debtor fit the requirements of the exemption. This Recommendation is consistent with the view of some commentators who believe that prepetition solicitations already are protected by the section 1125(e) safe harbor for potential violations of the securities laws.[1506]

Under the Commission's Recommendation, prepetition solicitation would be subject to significant constraints. The restrictions are effectively monitored and enforced because prepetition votes would be invalidated if the court ultimately determined that the plan proponent failed to meet the requisite standards.[1507] The expense and delay that accompany a second disclosure and re-solicitation provide a strong incentive for a debtor to make its best efforts to comply with the applicable disclosure standards.[1508] In addition, although the adequacy of disclosure would not

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[1505] *See* Memorandum from Jay M. Goffman to National Bankruptcy Review Commission regarding proposed amendments to Bankruptcy Code and Securities Laws relating to prepackaged bankruptcy cases, Ex. A (June 12, 1997) (comparing professionals' fees in traditional Chapter 11 cases to prepack cases).

[1506] Stephen H. Case & Mitchell A. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations*, 1991 SURV. AM. L. 75, 184; Richard M. Cieri, *et al.*, *Safe Harbor in Unchartered Waters -- Securities Law Exemptions Under Section 1125(e) of the Bankruptcy Code*, 51 BUS. LAW. 379, 409 (1996).

[1507] *See, e.g.*, *In re* Colorado Springs Spring Creek Gen. Imp. Dist., 177 B.R. 684 (Bankr. D. Colo. 1995) (finding securities law deficiencies in prepetition disclosures and denying confirmation); *In re* Southland Corp., 124 B.R. 211 (Bankr. N.D. Tex. 1991) (finding defects in prepetition solicitation and requiring resolicitation).

[1508] "The difficulties in the mechanics of the Southland solicitation illustrate that debtor's be governed by nonbankruptcy law, federal or state agencies regulating securities could be heard on the issue of whether the plan proponent provided adequate information in the context of the situation.[1509]

This Proposal would have a very limited application overall. If a debtor wanted to use a prepack as an alternative to an unsuccessful out-of-court workout, it could not rely on the proposed extension of the exemption for its workout solicitation. The exemption would be available only to those plan proponents that solicit directly in connection with a future plan of reorganization under title 11 and file a bankruptcy petition within 120 days after commencing solicitation.

Moreover, the proposed procedure would be available only for those companies that are subject to and in compliance with the periodic reporting requirements of the Securities Exchange Act of 1934.[1510] Making the availability of this additional source of information a prerequisite to the use of this exemption provides extra assurance that public investors have ample information about a company soliciting prepetition for a prepack in accordance with the bankruptcy law standards.[1511] Informal consultations with the Securities and Exchange Commission staff indicate that this approach would be satisfactory to alleviate concerns about insufficient information.

Attempts to obtain majority support for a prepackaged plan may be unsuccessful and the company therefore may choose not to file a bankruptcy petition. Such a company still would be protected by the exemption in this instance, although its unsuccessful solicitation would not be effective for any purpose. This is consistent with the approach already taken by the Bankruptcy Code's rules and standards: if a

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counsel must utilize extreme care to assure that disclosure is adequate and that the procedure of the solicitation cannot be attacked." Marc S. Kirschner, *et al.*, *Prepackaged Bankruptcy Plans: The Deleveraging Tool of the '90s in the Wake of OID and Tax Concerns*, 21 SETON HALL L. REV. 643, 674 (1991).

[1509] 11 U.S.C. § 1125(d) (1994).

[1510] 15 U.S.C. § 78m (1994). Periodic reporting requirements apply to companies registered on any national securities exchange under section 12(b) of the '34 Act and to companies with more than five hundred shareholders of record in any class of securities and with more than $10 million in assets. *Id.*, 781(b) . *See also* 17 C.F.R. S 240.12g-1 (1996) (raising asset threshold to $10 million). *See* generally Stephen J. Choi, *Company Registration: Toward a Status-Based Antifraud Regime*, 64 U. CHI. L. REV. 567 (1997) (describing current system, presenting arguments for status-based antifraud regime).

[1511] The types of transactions that may be involved for prepacks of very small companies not subject to the '34 Act periodic reporting requirements may be eligible for other registration exemptions under nonbankruptcy law, such as that for private placements. *See, e.g.*, 15 U.S.C. § 77d(2) (1994); 17 C.F.R. 230.144A (1994).

debtor solicits votes after the court approves its disclosure statement but cannot get a plan confirmed, for example, the debtor is not liable for failing to register with the SEC in connection with the solicitation. The ultimate success or failure of the solicitation does not determine the applicable standards under current law, and it should not do so in a prepack solicitation. Any other rule would nullify the proposed prepetition exemption because it would force a corporation seeking to complete a prepack to take an expensive "belts and suspenders" approach and comply with otherwise applicable registration and prospectus requirements just in case it did not obtain the requisite votes to go forward and file a prepackaged plan. The exemption would not protect an entity from liability under the securities laws if the entity used the solicitations for another type of workout, such as an exchange offer.

Competing Considerations. Some might be concerned that businesses could take advantage of the ability to solicit plan votes without complying with the specific requirements of the securities laws. Others have recommended fewer restrictions on the companies that can use the exemption and a longer prepetition period for solicitation under the bankruptcy standards, arguing that large companies have many players and types of outstanding debt that necessitate a long negotiation period. The Commission took a middle ground and developed a Proposal that is very limited in its application, time, and scope. If this approach yields satisfactory results in terms of enabling successful reorganization with minimized administrative costs, Congress ultimately might consider an expansion of the applicability of bankruptcy requirements to prepetition solicitation.

Others express a different concern. Rather than concluding that the Proposal offers too much protection for companies attempting a prepackaged bankruptcy, they are concerned that this Proposal offers too little protection. This Proposal may increase the risk that a prepack will be unwound after the fact because a court interprets the "adequate information" standard differently from the debtor's professionals. If this were the case, the proposed change would not promote the use of prepacks. Of course, nothing in this Proposal would put the debtors in any worse position than current law. Other nonbankruptcy exemptions from solicitations would continue to apply, but it is possible that this Recommendation does not go far enough to encourage and protect prepackaged bankruptcies.

2.4.18 *Postpetition Solicitation for a Prepackaged Plan of Reorganization*

Section 1125(b) should be amended to provide that the acceptance or rejection of a plan may be solicited after the commencement of a case under title 11 but before the court approves a written disclosure statement from those classes that were solicited for the plan prior to the filing of the bankruptcy petition.

The Bankruptcy Code expressly contemplates that a company that has not yet filed for bankruptcy may begin to make disclosures about its intended Chapter 11 plan and commence the solicitation process.[1512] However, once that debtor files for bankruptcy, the rules governing solicitation change. Section 1125(b), which governs "Postpetition Solicitation and Disclosure," authorizes solicitation postpetition only after the court has approved a disclosure statement.[1513] Literally interpreted, this provision precludes the postpetition continuation or completion of the solicitation process begun prepetition in a prepack. This has two consequences. The debtor who has not completed every aspect of a prepack solicitation at the moment of filing a petition must forfeit many of the advantages of a prepack by returning to the much slower Chapter 11 track when the process may be almost complete. In addition, the debtor in the midst of negotiating a prepack is vulnerable to having the process derailed by any creditor who decides to file an involuntary petition.[1514] The threat to make such a filing gives a sophisticated creditor a bargaining advantage based on nothing more than the ability to terminate the debtor's prepack negotiations.

To promote out-of-court collective negotiation and to reduce the leverage of those who have nothing to lose by causing delay, the Commission recommends an amendment to permit the plan proponent to continue its solicitation postpetition. This would minimize the incentives for dissenting creditors to delay or to threaten to derail a plan. A complete restriction on postpetition solicitation in a prepack does not serve a significant function when the debtor already has made disclosures and solicited votes prepetition. Once again, the Proposal is narrow in scope: the plan proponent could continue to solicit only holders of claims in those classes that were solicited prepetition.[1515] A broader rule would enable the debtor to solicit one class prepetition

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[1512] *See* 11 U.S.C. § 1102(b)(1) (1994) (prepetition creditors' committees); 11 U.S.C. § 1126(b) (1994) (setting forth source of standards for prepetition disclosure and solicitation); 11 U.S.C. § 1121(a) (1994) (plan can be filed with petition); FED. R. BANKR. P. 3018(b) (rules governing prepetition voting).

[1513] 11 U.S.C. § 1125(b) (1994) ("An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.").

[1514] *See, e.g.*, *In re* Resorts Int'l, Inc., 199 B.R. 113 (Bankr. D.N.J. 1996) (creditors filed involuntary case against debtor while in prepack negotiations); *In re* New Valley Corp., 168 B.R. 73 (Bankr. D.N.J. 1994) (same); Nicholas P. Saggese & Alesia Ranney-Marinelli, A PRACTICAL GUIDE TO OUT-OF-COURT RESTRUCTURINGS AND PREPACKAGED PLANS OF REORGANIZATION, § 4.04[C], at 4-83 (2d ed. 1993) (Code offers no clear guidance as to status of prepackaged plan once petition is filed, which might occur when dissatisfied creditors file involuntary petition to derail plan).

[1515] Rule 3018 of the Federal Rules of Bankruptcy Procedure already requires that prepetition as a means to avoid the general rule against solicitation prior to court approval of the disclosure statement, which is not the intent of this Proposal. In the absence of prepetition solicitation of those parties under section 1126(b), the recommended change would not authorize a plan proponent to solicit the votes of creditors or equity holders prior to approval of a disclosure statement. In addition, although this Proposal would permit the continuation of the prepetition solicitation process, it does not change the fact that the adequacy of the disclosure or the validity of the solicitation and voting process still would be reviewed by the court. Like prepetition solicitation under the current rules, votes obtained in this interim postpetition period would be subject to later disqualification if the court ultimately did not approve the debtor's disclosures. A plan proponent bears the risk of potential retroactive invalidation of these votes if it is not scrupulous in its compliance with disclosure requirements. No other rules dealing with claims, including any claims trading rules, would be changed by this Proposal.

The Commission's proposed change would clarify ambiguity regarding postpetition continuation of prepetition solicitation under current law. Some commentators have suggested that continued solicitation already is permissible.[1516] This question turns on the definition of the "solicitation" event, which allows the argument that incomplete prepetition solicitation continues to be protected even when it runs over into the post-filing period. The Commission does not take a position on the status of current law, and notes only that the proposed clarification would encourage prefiling negotiation and solicitation.

Competing Considerations. Some people advocate a much more comprehensive change: they recommend that the Code enable all plan proponents to solicit prior to disclosure statement approval, or alternatively that the Code be amended to abolish the disclosure statement requirement. These more substantial recommendations arguably would speed up the Chapter 11 process and eliminate formalities that some perceive to be unnecessary. The Commission's Proposal takes a conservative approach and addresses only the narrow issue of postpetition solicitation in prepacks to promote the efficient use of prebankruptcy negotiations and solicitation. The success of this small change might prompt further consideration of more significant changes at a later date.

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solicitation be made to substantially all members of the class. FED. R. BANKR. P. 3018.

[1516] *See* Nicholas P. Saggese & Alesia Ranney-Marinelli, A PRACTICAL GUIDE TO OUT-OF-COURT RESTRUCTURINGS AND PREPACKAGED PLANS OF REORGANIZATION, § 4.04[C], at 4-86 (2d ed. 1993) (explaining alternative views of section 1125(b) restriction as applied to prepacks); Richard M. Cieri, *et al.*, *Safe Harbor in Unchartered Waters -- Securities Law Exemptions Under Section 1125(e) of the Bankruptcy Code*, 51 BUS. LAW. 379, n.50 (1996) (noting impracticability of applying section 1125(b) to prepack solicitations).

Others taking the opposite view might argue that even the Commission's limited Proposal would undermine the disclosure requirements because courts may be less inclined to invalidate votes after the fact on the basis of minor errors in the disclosure statement. If one were very concerned about inadequacy of information, one way to ameliorate this concern might be to authorize the conditional approval of disclosure statements. The Bankruptcy Code currently authorizes this approach for debtors that elect to be treated as small businesses.[1517] Alternatively, some commentators have endorsed the use of prepetition declaratory judgments approving disclosure statements, which would address this problem as well.[1518]

2.4.19 *Elimination of Prohibition on Nonvoting Equity Securities*

> **Congress should amend section 1123(a)(6) to eliminate the requirement that the charter of the reorganized corporate debtor prohibit the issuance of nonvoting equity securities. Section 1123(a)(6) should otherwise remain unchanged.**

A plan of reorganization must have certain contents and features to be confirmed. These criteria are set forth in section 1123. Section 1123(a)(6) of the Bankruptcy Code requires that a reorganized debtor's corporate charter include a provision that prohibits the debtor from issuing nonvoting stock.[1519] This statutory requirement had its roots in a similar requirement in pre-Code law.[1520] In the 1930s,

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[1517] *See* 11 U.S.C. § 1125(f) (1994).

[1518] Stephen H. Case and Mitchell Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations*, 1994 ANN. SURV. AM. L. 75.

[1519] Section 1123(a) provides:

> Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall - . . . (6) provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in paragraph (5)(B) or (5)(C) of this subsection, of a provision prohibiting the issuance of nonvoting equity securities, and providing, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends.

11 U.S.C. § 1123(a) (1994).

[1520] *In re* Acequia, Inc., 787 F.2d 1352 (9th Cir. 1986) (noting that section 1123(a)(6) was derived from 11 U.S.C. § 616 of Bankruptcy Act of 1898 and copied almost verbatim), *citing* S.REP. NO. 95-989, at 119, *reprinted in* 1978 U.S.C.C.A.N. 5787, 5905 (indicating interest in ensuring that

Congress and the Securities and Exchange Commission were concerned that insiders retained too much control over reorganization to the exclusion of public stockholders.[1521] The prohibition on nonvoting stock was intended to promote the fair distribution of voting power to elect the managers of a reorganized debtor.

While this provision may have served that function in the 1930s, the multiplicity of corporate structures used today, along with the active participation of classes of claims negotiating for equity participation, leave the provision with little relevance in the modern corporate world.[1522] The inclusion of this provision in the Bankruptcy Code has been the subject of much criticism.[1523] More importantly, there seems to be little evidence that this prohibition has had any beneficial effects. First, it is easily circumvented. A debtor might create a voting trust or issue preferred stock with limited voting rights, which do not comport with the underlying purpose of the provision but are in technical compliance with the statutory requirement.[1524] Second, Chapter 11 specifically provides tools that deal with the earlier concerns of Congress and the Securities and Exchange Commission. For example, the remainder of section 1123(a)(6) and 1123(a)(7)[1525] more effectively address the concern of excessive

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investors could maintain voice in selection of management of reorganized firm).

[1521] *See* 7 COLLIER ON BANKRUPTCY ¶ 1123.01[f][6] (Lawrence P. King, et al. eds., 15th 1996); *S.E.C. Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective Committees, Part I, 903* (1937), Part VIII 156 (1940).

[1522] *Accord* GINSBERG & MARTIN ON BANKRUPTCY, § 13.09[H] (Robert E. Ginsberg et al. eds. Supp. 1997) ("These provisions, which are a carryover from old Chapter X and represent the thinking of the Securities and Exchange Commission in the 1930s about how large publicly held corporate debtors are reorganized, are archaic").

[1523] *See, e.g.*, Letter of May 8, 1997 from L.E. Creel, III to Brady Williamson (deeming provision's inclusion to be a "glitch"); 7 COLLIER ON BANKRUPTCY ¶ 1123.01[f][6] (Lawrence P. King et al. eds. 1996) ("It is suggested that the inclusion of section 1123(a)(6) was not well considered and represents an intrusion of the paternalistic hand of Chapter X into practice under Chapter 11 of the Bankruptcy Code"); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551, 555 (1995) (noting that "anomalous" provision was retained as political concession).

[1524] *See* Richard L. Epling, *Fun with Nonvoting Stock*, 10 BANKR. DEV. J. 17, 20 (1993/1994) (noting case law permitting restrictive voting trusts in connection with plan, and describing other methods that comply with section 1123(a)(6) restrictions but could disenfranchise common shareholders); REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT, FINAL REPORT 290 (1994); Kenneth N. Klee, *Adjusting Chapter 11: Fine Tuning the Plan Process*, 69 AM. BANKR. L.J. 551, 555 (1995) (noting confusion over whether securities with only limited voting rights satisfy the section 1123(a)(6) requirement).

[1525] Section 1123(a)(7) provides that a plan shall "contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director, or trustee under the plan and any successor to such insider control over management, as do the Code's disclosure and confirmation requirements, which provide parties with more direct means to prevent disenfranchisement. Some commentators also have noted that a literal reading of the charter provision requirement is especially problematic when the debtor is being acquired by a preexisting corporation that was not organized for the purpose of making this acquisition.[1526]

There may be valid reasons to make nonvoting stock available to parties in interest. The question of nonvoting stock is an issue that arises in large cases, in which all parties benefit from the availability of a full panoply of corporate ownership devices. The issue becomes particularly significant when the debtor proposes to issue new stock to unsecured creditors in full or partial satisfaction of their claims.[1527] There are restrictions on the ability of some creditors, such as banks, to hold voting securities.[1528] The workout process also would be facilitated if there were greater flexibility in dealing with a debtor's securities.[1529]

For all of these reasons, the Commission recommends the repeal of this portion of section 1123(a)(6).

Competing Consideration. Some parties might believe that the concerns of the Securities and Exchange Commission in the 1930s regarding insider control may hold true today and may warrant protections against disenfranchisement. Even if one thinks that this is the case, however, other requirements of Chapter 11 are more responsive to this concern than a nonvoting stock prohibition, which seems to be an easily-circumvented and ineffective solution to the alleged insider control problem.

2.4.20 *Postconfirmation Plan Modification*

11 U.S.C. § 1127(b) should be amended to permit modification after confirmation of a plan until the later of 1) substantial consummation or 2) two years after the date on which the order of confirmation is entered.

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officer, director, or trustee." 11 U.S.C. § 1123(a)(7) (1994).

[1526] *See* GINSBERG & MARTIN ON BANKRUPTCY, § 13.01[H] at 13-61 (Robert E. Ginsberg et al. eds. Supp. 1997).

[1527] *See* Richard L. Epling, *Fun with Nonvoting Stock*, 10 BANKR. DEV. J. 17 (1993/1994).

[1528] 12 U.S.C. § 1843 (1994) (precluding banks from holding voting equity securities).

[1529] Letter of May 8, 1997 from L.E. Creel, III to Brady Williamson. *See also* Epling, 10 BANKR. DEV. J. at 21 (noting that primary issue should be whether creditor class votes to accept nonvoting stock).

All other restrictions on postconfirmation plan modification in section 1127(b) should remain unaltered.

Even the most carefully crafted plans of reorganization sometimes encounter circumstances that warrant adjustment. Events that might be out of the control of the reorganized debtor can change circumstances sufficiently to put the plan at risk. At that point, the debtor could fail in its obligations and be liquidated, or the debtor could file another bankruptcy petition.[1530] These options have extreme consequences, but they basically are the only options that current law provides. A less extreme option would be court-approved plan modification. Modifying the plan would permit stabilization and continuation of the enterprise and productivity, maintenance of employees' jobs, and continuation of distributions to creditors.

Under current law, a plan proponent or reorganized debtor can seek to modify a confirmed plan of reorganization with court approval under only highly circumscribed conditions, but has only a very brief time period to do so following confirmation.[1531] Modification is prohibited after "substantial consummation," a term of art in the Bankruptcy Code. According to the Code, substantial consummation occurs when the debtor has commenced making distributions under the terms of the

[1530] Successive Chapter 11 filings have caused a great deal of confusion. *See generally* David A. Lander & David A. Warfield, *A Review and Analysis of Selected Post-Confirmation Activities in Chapter 11 Reorganizations*, 62 AM. BANKR. L.J. 203, 232 (1988). The Code does not expressly prohibit repeated Chapter 11 filings. *See In re* Elmwood Dev. Co., 964 F.2d 508, 511 (5th Cir. 1992) (second Chapter 11 petition not per se invalid), *citing* Johnson v. Home State Bank, 111 S. Ct. 2150 (1992) (refilings in Chapters 7 and 13 not prohibited categorically). The Bankruptcy Act of 1898 imposed a six-year bar on discharge (but not filing) for reorganizing businesses under some circumstances, but Congress include no such provision in the 1978 Code. Yet, some courts have held that section 1127 prohibits a subsequent Chapter 11 case that modifies the terms of the original plan, deeming this to be a "bad faith" filing subject to conversion or dismissal. *See In re* Sportpages Corp., 101 B.R. 528, 529 (N.D. Ill. 1989); *In re* Roxy Real Estate Co., 170 B.R. 571 (Bankr. E.D. Pa. 1993); *In re* AT of Maine, Inc., 56 B.R. 55 (Bankr. D. Me. 1985); *In re* Northampton Corp., 39 B.R. 955 (Bankr. E.D. Pa. 1984), *aff'd*, 59 B.R. 963 (E.D. Pa. 1984). Others will permit repeat Chapter 11 filings when the debtor illustrates a change of circumstances. *In re* Casa Loma Assocs., 122 B.R. 814, 818-19 (Bankr. N.D. Ga. 1991) (changed circumstances, unknown at time of substantial consummation of prior plan, have substantially affected debtor's ability to perform plan); *accord* Elmwood, 964 F.2d at 511 ("we agree that unanticipated circumstances may justify valid successive request for Chapter 11 relief"). The Court of Appeals for the Seventh Circuit upheld a second Chapter 11 filing for purposes of an orderly liquidation. *See* Freuhauf Corp. v. Jartran, Inc., 886 F.2d 859 (7th Cir. 1989).

[1531] "The proponent of a plan or the reorganized debtor may modify such plan at any time after confirmation of such plan and before substantial consummation of such plan, but may not modify such plan so that such plan as modified fails to meet the requirements of sections 1122 and 1123 of this title. Such plan as modified under this subsection becomes the plan only if circumstances warrant such modification and the court, after notice and a hearing, confirms such plan as modified, under section 1129 of this title." 11 U.S.C. § 1127(b) (1994).

plan, substantially all property has been transferred that is to be transferred, and the debtor/successor has assumed the management of the reorganized debtor.[1532] The Code therefore permits modification, but typically for only a few days or weeks following confirmation. This is not enough time for the reorganized debtor to anticipate or solve unforseen problems.

Even aside from the short time limitation, the Bankruptcy Code imposes quite stringent requirements on modification. Numerous substantive and procedural protections for creditors and equity holders in Chapter 11 remain intact during this modification process. In addition to gaining court approval, modification must satisfy the requirements of sections 1122 (classification) and 1123 (mandatory and permissive plan requirements) and the confirmation requirements in section 1129. Satisfying these requirements—in the plan confirmation process or the modification process—is not an easy task.

These substantive and procedural requirements for statutory modification prevent improvident and unfair plan modifications and protect the interests of creditors and equity holders, thus it is not necessary to maintain such stringent time limitations on modification. In light of the potential benefits of permitting parties to negotiate for modification, the Commission believes it is unduly restrictive to impose such a short time limitation, which essentially precludes almost any plan modification. It is nearly impossible for a debtor to know that a modification might be necessary that early in the postconfirmation process. The Commission's proposed amendment would enlarge the window of opportunity to modify, but would *not* otherwise change the strict rules that define the parameters of permissible modifications. Thus, the fact that modification would be available for a longer time period does not mean that it would be a realistic option in all cases.

Because class voting governs the modification process, the majority of each class of creditors—and not just the debtor or plan proponent—still would decide whether a modification is prudent. If creditors have lost confidence in the ability of a debtor to reorganize, a modification will not be possible, notwithstanding the fact that the modification was not time-barred. Falling within the modification period is necessary, but certainly not sufficient, in demonstrating that the relief requested should be granted.

This amendment would have several additional salutary consequences. First, the Proposal would reduce litigation by limiting the need to challenge and interpret the term "substantial consummation." The term has caused a fair amount of confusion,[1533] and yet under any analysis it occurs extremely early in all but the most

[1532] 11 U.S.C. § 1101(2) (1994).

[1533] *See* Benjamin Weintraub & Michael J. Crames, *Defining Consummation, Effective Date* unique cases and well before the two-year anniversary of plan confirmation.[1534] The Proposal therefore would eliminate litigation on this point in most instances.

Second, this amendment would assure that creditors have the opportunity to participate in the process of effectuating any plan changes. In the absence of authority to permit modifications after substantial consummation,[1535] some courts have permitted "clarifications" or "variations" on extant plans.[1536] Because there would be no need for these shortcuts, this Proposal should prevent parties from circumventing the protections of section 1127(b) and the plan negotiation process.[1537]

An expanded time frame also may avert the request for a successive filing. In their empirical study of 43 publicly-held businesses in Chapter 11 in the 1980s, Professors LoPucki and Whitford found that a significant number of companies

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of Plan of Reorganization and Retention of Postconfirmation Jurisdiction: Suggested Amendments to Bankruptcy Code and Bankruptcy Rules, 64 AM. BANKR. L.J. 245, 247 (1990).

[1534] *See*, e.g., *In re* Bullion Hollow, Inc., 185 B.R. 726, 728 (W.D. Va. 1995), *citing In re* Hayball Trucking, Inc., 67 B.R. 681 (Bankr. E.D. Mich.1986); *In re* Earley, 74 B.R. 560 (Bankr. C.D. Ill.1987); *In re* Bedford Springs Hotel, 99 B.R. 302 (Bankr. W.D. Pa.1989); *In re* Burlingame, 123 B.R. 409 (Bankr. N.D. Okla.1991); *In re* Burnsbrooke Apts. of Athens, Ltd., 151 B.R. 455 (Bankr. S.D. Ohio 1992); *In re* Dam Road Mini Storage, 156 B.R. 270 (Bankr. S.D. Cal.1993). *But see In re* Heatron, 34 B.R. 526 (Bankr. W.D. Mo. 1983) (substantial consummation had not occurred because distribution to creditors were little more than halfway completed); Jorgenson & Jorgenson v. Federal Land Bank, 66 B.R. 104 (B.A.P. 9th Cir. 1986) (adopting *Heatron* standard that distributions "must be more than halfway" completed); *accord In re* Hotel Assocs. of Tuscon, 165 B.R. 470 (B.A.P. 9th Cir. 1994) (same).

[1535] *See*, *e.g.*, *In re* Best Products, Inc., 177 B.R. 791, 802 (S.D.N.Y. 1995) ("relief requested by the RTC would, if granted, be tantamount to confirmation of a plan that is different than the one that was proposed by the Debtors and approved by 97% of the creditors. The court cannot adopt any modification that materially alters the plan and adversely affects a claimant's treatment.").

[1536] *See*, *e.g.*, IRS v. APT Indus., Inc., 128 B.R. 145 (W.D.N.C. 1991) (postconsummation order directing IRS in application of trust fund taxes was clarification, not modification). *See also* State Gov't Creditors' Comm. for Property & Damage Claims v. McKay (*In re* Johns-Manville Corp.), 920 F.2d 121, 128 (2d Cir. 1990) (suspending operations of claims resolution facility was "variation with respect to timing and claims processing"), *cert. denied sub nom.* MacArthur Co. v. Johns-Mansville Corp., 488 U.S. 868 (1988).

[1537] *See* Findley v. Blinken (*In re* Joint E. & S. Dist. Asbestos Litig.), 982 F.2d 721 (2d Cir. 1992), *modified on reh'g*, 993 F.2d 7 (2d Cir. 1993) (restructuring trust pursuant to settlement of non-opt-out class action was impermissible plan modification); *In re* Stevenson, 148 B.R. 592, 596 (D. Idaho 1992) (proposed modification improperly created new plan regarding bank's allowed secured claim); *In re* U.S. Repeating Arms Co., 98 B.R. 138 (Bankr. D. Conn. 1989) (adding particular product liability action to unsecured class was modification subject to section 1127(b)); *In re* Charterhouse, Inc., 84 B.R. 147 (Bankr. D. Miss. 1988) (section 105(a) cannot be used to implement postconsummation modification).

emerged from Chapter 11 with significantly more debt than comparable companies in the same industry, and many of those companies refiled for bankruptcy.[1538] To the extent that such repeat trips into bankruptcy are prompted by the need to de-leverage as a consequence of the first filing, a more realistic modification period might provide more cost-efficient resolution while being equally protective of creditors' rights. Statements of experienced practitioners and judges indicate that the number of cases that result in failure or attempts at successive Chapter 11 filings might be reduced by expanding the time limit for plan modification.[1539]

Competing Considerations. A longer modification period might lessen the perceived finality of the confirmation process. For this reason, some might be concerned that an extended modification period could discourage parties from working hard to determine with precision the correct business and financial decisions before confirmation. Most parties are likely to use their best estimates and to negotiate for the most realistic options in a reorganization, even if they know they will be permitted to return if something goes wrong; they recognize that modification, while better than re-filing, is costly, uncertain, and not preferable to working out all possible issues in the first reorganization attempt. This Proposal would most likely be used to address unforeseen changes and events.

It also may be argued that hurdles to postconsummation plan alterations exert a discipline on management of the reorganized entity after consummation of the plan. Allowing postconsummation modification might provide a safety valve that could reduce this discipline and could result in a greater rate of debtor recidivism. Notwithstanding the impact of the proposed change on "management psychology," this Proposal would streamline the process of dealing with postconsummation problems that might necessitate adjustment.

[1538] Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 CORNELL L. REV. 597, 606 (1993). Of the thirty-eight companies in which an entity survived confirmation, twelve filed a subsequent bankruptcy petition. Not all of the refilings necessarily were attributable to an overload of debt. *Id.* at 606, n.44.

[1539] *See*, e.g., Memorandum from Leon S. Forman to Chapter 11 Working Group of National Bankruptcy Review Commission on Post-Confirmation Modification 2 (Mar. 21, 1997); Robert D. Martin, Bankruptcy Judge, *et al. Plan Default and Post Confirmation Issues*, at 16 (1995) (citing inability to modify after substantial consummation as cause of Chapter 11 serial filings). Expansion of the modification time limits partly would address an argument used to disallow subsequent filings, namely that subsequent Chapter 11 petitions are impermissible if they amount to a *de facto* postconsummation modifications. *See In re* Elmwood Dev. Co., 964 F.2d 508, 511 (5th Cir. 1992) (second Chapter 11 petition not per se invalid, but cannot be used to avoid conditions of first plan); *accord In re* Sportpages Corp., 101 B.R. 528, 529 (N.D.Ill. 1989); *In re* Roxy Real Estate Co., 170 B.R. 571 (Bankr. E.D. Pa. 1993); *In re* AT of Maine, Inc., 56 B.R. 55 (Bankr. D. Me. 1985); *In re* Northampton Corp., 39 B.R. 955 (Bankr. E.D. Pa.), *aff'd*, 59 B.R. 963 (E.D. Pa. 1984).

Some also might argue that the ability to reopen plans of reorganization and utilize bankruptcy procedures to readjust the capital structure of the reorganized entity for an extended period after plan consummation will impair the value of reorganization securities and disrupt the ability of debtors to enter into postconsummation transactions. The argument is that securities that can have their payment terms modified by majority vote after the fact will trade at a discount to securities with a conventional unanimous consent requirement. Similarly, uncertainty over the ownership, capital and management structure of the reorganized firm may deter third parties from dealing with it. These concerns, though understandable, need to be balanced against the potential risks of a future bankruptcy if modification is not allowed. If the extension of the modification right for the limited period proposed is infrequently utilized and only in the most extreme circumstances, the risks entailed are acceptably small.

Alternatively, some who addressed the Commission urged adoption of a significantly longer modification period, such as three or six years. They argued that a complex reorganization could take years to implement, and the parties should be free to come back to court with proposals for modification. So long as the debtor is required meet all Chapter 11 conditions, they argued that there would be little harm and much potential benefit to permitting modifications years after confirmation. The Commission was concerned that reorganized debtors not stay in the shadow of the bankruptcy court this long, which tipped the balance against this approach. Until there is more experience with a two-year modification period, the Commission recommends that the time for modification not be further extended.

Some advocate that the Code should permit plans to have provisions setting forth the terms of modification that would not require court control or approval.[1540] Permitting modification without court approval under the terms of a plan could unravel the strict requirements—and important creditor protection—of plan confirmation. This approach would preserve very little court supervision over the parties who would purport to act under the auspices of the bankruptcy laws. To the extent that parties currently can include a plan provision dealing with modification of securities issued under a plan of reorganization, such provisions would remain equally valid.

[1540] *See* REFORMING THE BANKRUPTCY CODE: THE NATIONAL BANKRUPTCY CONFERENCE'S CODE REVIEW PROJECT, FINAL REPORT 54 (rev. ed. 1997) (recommending that the Code permit modification after substantial consummation without supervision if plan of reorganization provides for such modifications).

[Commissioner note from the Chapter 11 Working Group: Jay Alix, Babette Ceccotti and Hon. Robert Ginsberg]

Note on Section 1113

Section 1113 permits a Chapter 11 debtor to seek modification of a collective bargaining agreement through an expedited form of collective bargaining and, absent consensual modifications, apply for court approval to reject the agreement under standards more stringent than those applicable to ordinary commercial contracts. The statute represents an effort to accommodate national policies favoring collective bargaining, in recognition of its important role in maintaining labor and economic stability, with bankruptcy goals encouraging reorganization. Accordingly, the provisions of section 1113 are designed, in principal part, to promote collective bargaining rather than court intervention in private collective bargaining matters.[1541] Since the enactment of section 1113, the courts' attempts to combine labor relations principles with bankruptcy policies in interpreting section 1113 have not always served the dual goals intended by the statute. One such instance is singled out for cautionary observation.

In *Sheet Metal Workers' International Association, Local 9 v. Mile Hi Metal Systems, Inc.*, 899 F.2d 887, 891 (10th Cir. 1990) ("*Mile Hi*") the Court of Appeals accepted that a contract proposal made pursuant to section 1113(b)(1)(A) could include proposed modifications, which, if implemented, would violate the labor laws as unfair labor practices.[1542] The court concluded that such a proposal "does not *per se* fail to satisfy" the statutory requirements that it must provide for "necessary modifications. . .that are necessary to permit the reorganization of the debtor" and that are "fair and equitable" to all parties.[1543] The court's additional conclusions that "[t]here may be cases where a necessary proposed modification is fair and equitable

[1541] *See In re* Century Brass Products, Inc., 795 F.2d 265, 272-3 (2d Cir. 1986); *In re* Garofalo's Finer Foods, 117 B.R. 363, 371 (Bankr. N.D. Ill. 1990).

[1542] *See* 29 U.S.C. §158 (1994).

[1543] Under this provision, "prior to filing an application seeking rejection of a collective bargaining agreement, the debtor in possession . . . shall--(A) make a proposal to the authorized representative of the employees covered by such agreement, based upon the most complete and reliable information available at the time of such proposal, which provides for those necessary modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor and assure that all creditors, the debtor and all of the affected parties are treated fairly and equitably[.]" 11 U.S.C. § 1113(b)(1)(A) (1994).

to all parties even though it contravenes labor law" and that the union would have to "work with the debtor on the allegedly illegal provisions . . . ."[1544] present obstacles to the advancement of labor policies and bankruptcy goals alike. Requiring the union to bear the burden of avoiding a contract proposal the debtor could not successfully advance outside of bankruptcy obstructs a process designed to achieve consensual agreement over terms and conditions of employment. Particularly where the bargaining process is designed to operate in an expedited manner, under the sometimes exigent circumstances of a bankruptcy case, permitting the debtor this option may only serve to hasten the end of the collective process, as evidenced by the *Mile Hi* opinion itself.[1545]

The court's prescription that a union must bargain over "illegal" proposals has affected the interpretation by other courts of the union's obligation to bargain over the employer's proposals under section 1113.[1546] This causes concern that the courts have distorted basic principles of good faith conduct between the parties, thus undermining the balance of goals reflected in section 1113 to the detriment of its intended purposes.

[1544] Mile Hi, 899 F.2d at 891-2.

[1545] Indeed, in this case, the business itself failed. *See* In re Mile Hi, 899 F.2d 887, 889, n.1 (10th Cir. 1990).

[1546] *See, e.g., In re* Hoffman Packing Bros., 173 B.R. 177, 188 (B.A.P. 9th Cir. 1994); *In re* Maxwell Newspapers, Inc., 146 B.R. 920, 928 (Bankr. S.D.N.Y. *rev'd* 149 B.R. 334, *aff'd in part, and rev'd in part*, 981 F.2d 85 (2d Cir. 1992); *In re* GCI Inc., 131 B.R. 685, 695 (Bankr. N.D. Ind. 1991); *In re* Garofalo's Finer Foods, Inc., 117 B.R. 363, 371 (Bankr. N.D. Ill. 1990). *See also In re* Blue Diamond Coal Co., 131 B.R. 633, 649 (Bankr. E.D. Tenn. 1991) (citing the union's attempt to make an arguably unlawful proposal as one factor indicative of its "unwillingness to bargain" and failure to meet the "good cause" standard under section 1113(c)(2)).