The Trouble with Unneeded Bankruptcy Reform:

The LSTA's Response to the ABI Chapter 11 Commission Report

October 2015

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THE LOAN SYNDICATIONS AND TRADING ASSOCIATION

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October 8, 2015

The Loan Syndications and Trading Association (LSTA) was established twenty years ago to promote a fair, orderly, efficient, and growing corporate loan market and to represent the interests of all market participants. Among our constituents are the banks, insurance companies, fund managers, and other institutional investors that originate, syndicate, and invest in secured corporate loans and that trade in the secondary market for performing, stressed, and distressed loans and claims. So, it was natural that when the American Bankruptcy Institute ("ABI") established its Commission to Study the Reform of Chapter 11 (the "Commission") in 2012, the LSTA took notice. Indeed, the Commission's mission statement, which identified "the expansion of the use of secured credit" and "the growth of distressed-debt markets" as two of the key factors necessitating reform of chapter 11, was effectively a call for the LSTA to participate actively in the process.

And so we did. We formed a working group and engaged a team from WilmerHale to represent us through every aspect of the Commission's process. We hosted the Commission's first field hearing, offered testimony at numerous hearings, gathered and distilled data, and wrote extensively. The Commission, to its great credit, encouraged and facilitated our participation in the process despite its knowledge that our views on reform diverged from those of many of the Commissioners. We are grateful to Sam Gerdano, the Executive Director of the ABI, Bob Keach and Al Togut, the Co-Chairs, Professor Michelle Harner, the Commission's Reporter, and to all the members of the Commission. We also note with sadness the passing of Harvey Miller, one of the ABI Commissioners and a giant in the world of bankruptcy and restructuring.

In December 2014, the Commission published a comprehensive 400-page report (the "Report") containing over 200 distinct proposals. We believe that many of those proposals not only would directly and profoundly affect the rights and recoveries of secured creditors and claims traders, but also, if adopted, would ultimately increase the cost, and reduce the supply, of credit to American companies, both performing and distressed. We decided that it was important to respond to those proposals in a comprehensive way. The WilmerHale team has spent the past 8 months parsing the Report, examining the testimony, and reviewing the academic and empirical research. They were ably assisted in their efforts by a small sub-committee of our working group, which read the drafts and made important comments and suggestions. Our response articulates our philosophical and practical disagreements with many of the Report's recommendations, and also identifies some proposals with which we agree. We would like to express our appreciation to Craig Goldblatt and Danielle Spinelli, who led the team from WilmerHale, and to team members Danielle D'Onfro, Allison Hester-Haddad, Joel Millar, and Jonathan Seymour. Over the past three and a half years, the WilmerHale team has advised and guided us in every aspect of this project, including organizing the first field hearing, presenting testimony of their own, undertaking a ground-breaking study of DIP loans, and, finally, drafting our response. We are deeply grateful.

We believe our response is an important document that will add to the robust discussion and debate around the need for bankruptcy reform, and we look forward to continuing to participate in that dialogue.

R Bram Smith

Bram Smith, Executive Director

Elliot Ganz, General Counsel

INTRODUCTION

The Loan Syndications and Trading Association (LSTA) has prepared this Response to the Report of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11, issued in December 2014. The Report proposes major changes to the current provisions of the Bankruptcy Code relating to creditors' rights, and particularly the rights of secured creditors, in corporate reorganization proceedings. Those changes, if adopted, would have a significant effect both on the bankruptcy process and on the functioning of the credit markets. As the leading trade association focused on the healthy functioning of a robust market in loans, and in particular leveraged loans—secured loans typically made to non-investment-grade companies—the LSTA believes that the Report's proposals deserve thorough and thoughtful analysis and consideration.[1] This Response is intended to contribute to that analysis and to inform the ongoing debate over whether "reform" of chapter 11 is needed and, if so, what such reform should entail.

In early 2012, the American Bankruptcy Institute, a well-respected bankruptcy trade association, assembled a blue-ribbon commission comprised of the leaders of the profession to study potential reform of the corporate reorganization provisions of chapter 11 of the Bankruptcy Code. The Commission's mission statement read, in full:

> In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors—with the attendant preservation and expansion of jobs—and the maximization and realization of asset values for all creditors and stakeholders.[2]

The premise behind the Commission's work, as expressed in the mission statement and elsewhere, was that, since the Bankruptcy Code was enacted in 1978, the increased use of secured credit, together with expanded secondary markets for debt, had undermined the effectiveness of the bankruptcy process. The Commission viewed its task as "propos[ing] reforms to Chapter 11" that would address that problem.

In pursuit of that mission, the Commission spent nearly three years engaged in an extensive review of bankruptcy law and potential reforms. It assembled 13 advisory committees, composed of corporate insolvency professionals with varying perspectives, to examine specific topics, including, among others, financing issues; distributional issues under plans; governance and supervision of cases; valuation; and asset sales.[3] The Commission also held 16 field hearings around the country, soliciting the views of a broad range of constituencies on a variety of issues.[4]

Because the Commission's mission statement identified the development of the leveraged lending market and secondary trading of distressed debt as factors that had purportedly undermined the effectiveness of chapter 11, the LSTA participated in the process as actively as possible. In view of the significant consequences that a wholesale revision of chapter 11 could have on the commercial loan market, the LSTA assembled a committee of its membership to lead its efforts in participating in and responding to the work of the Commission. It retained WilmerHale to advise it in those efforts. The LSTA hosted the first of the Commission's field hearings, at which witnesses with industry experience testified about the importance of the leveraged loan market to the broader economy.[5] Two of the

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[1] The LSTA is a not-for-profit trade association that represents a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The mission of the LSTA is to promote a fair, orderly, efficient, and growing corporate loan market and to provide leadership in advancing and balancing the interests of all market participants. The LSTA participates regularly as *amicus curiae* in cases raising questions of bankruptcy law that might affect the commercial debt markets, and courts have frequently relied on the LSTA's briefs. *See In re DBSD N. Am., Inc.*, 634 F.3d 79, 105 (2d Cir. 2010); *In re Enron Corp.*, 379 B.R. 425, 430 (S.D.N.Y. 2007); *In re Phila. Newspapers, LLC*, 422 B.R. 553, 555 n.5 (Bankr. E.D. Pa. 2010); *see also, e.g.*, Brief for the Loan Syndications and Trading Association et al., *RadLAX Gateway Hotel LLC v. Amalgamated Bank*, 132 S. Ct. 2065 (2012), available *at* 2012 WL 822951; Brief of Loan Syndications and Trading Association et al., *Bank of America v. Caulkett*, 135 S. Ct. 1995 (2015), available *at* 2015 WL 412047.

[2] American Bankruptcy Institute Commission To Study the Reform of Chapter 11, *Final Report and Recommendations* 3 (2014) (Report).

[3] *Id.* at 13-14.

[4] *Id.* at 15. The written and oral testimony of the witnesses at the field hearings can be found at http://www.commission.abi.org.

[5] The hearing was held on October 17, 2012. Edward Altman of the New York University Stern School of Business, Ted Basta of the LSTA, John Greene of Halcyon Asset Management LLC, Edith Hotchkiss of the Wallace E. Carroll School of Management at Boston College, Daniel B. Kamensky (on behalf of the Managed Funds Association), A.J. Murphy of Bank of America Merrill Lynch, and Lee Shaiman of

WilmerHale lawyers involved in preparing this response testified at separate Commission field hearings on issues affecting the rights of secured creditors in bankruptcy.[6] The LSTA also gathered data and prepared an empirical study on the use of debtor-in-possession (DIP) financing, sharing its data with the Commission.[7]

In December 2014, the Commission issued a hefty report, nearly 400 pages long, that proposes an ambitious set of reforms to existing corporate reorganization law. Consistent with the Commission's mission statement, the Report asserts that the greater complexity of firms' capital structures, their increased reliance on secured credit, the shift toward intangible assets, and the rise of claims trading have left the 1978 Bankruptcy Code, in many respects, obsolete. "Moreover, anecdotal evidence suggests that chapter 11 has become too expensive … and is no longer capable of achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases …, or helping to rehabilitate viable companies that cannot afford a chapter 11 reorganization."[8] According to the Report, the witnesses who testified before the Commission "perceived" that, as compared to the early years of the Code, there are now more and quicker sales of a debtor's assets, fewer stand-alone reorganizations, lower recoveries for unsecured creditors, and higher costs associated with chapter 11.[9]

In short, the Report's recommendations are based in large part on the perception that secured creditors now exercise greater control over chapter 11 proceedings than they once did, to the potential detriment of the debtor and unsecured creditors. The original "balance" the Code struck between "preserving a debtor's need to rehabilitate" and maximizing value for creditors, the Report suggests, is now askew, and changes are necessary to shift power back to the debtor and to unsecured creditors.[10]

Toward that end, the Report makes a number of recommendations that would weaken creditors' existing protections under the Bankruptcy Code. Among other things, the Report advocates diluting the "adequate protection" the Code provides secured creditors against depreciation of their collateral during the chapter 11 process.[11] It advocates requiring senior secured creditors in large bankruptcy cases to distribute value to out-of-the-money junior creditors to achieve a "fairer" distribution of assets.[12] The Report also recommends imposing stringent limitations on the terms of DIP financing and on sales of a debtor's assets under § 363 of the Bankruptcy Code, both of which will also affect secured creditors.[13] Finally, the Report proposes an ambitious new scheme for so-called "small and medium-sized enterprises" (SMEs) that would permit owners of such businesses to retain an ownership interest in, and control over, the businesses even if creditors are not paid in full.[14]

It is important to note that some of the Report's proposals would benefit secured creditors. For example, the Report recommends amending the Code to clarify that secured creditors are entitled to a market rate of interest on their claims under a cramdown plan.[15] The Report also recommends retaining secured creditors' current credit-bidding rights and clarifying that any potential chilling effect of a credit bid, by itself, is not cause to deny

Blackstone testified. Each speaker's written statement and oral testimony, along with a video of the hearing, can be found at http://www.commission.abi.org.

6 *See Statement of Craig Goldblatt: NCBJ Field Hearing Before the ABI Comm'n To Study the Reform of Chapter 11* (Oct. 26, 2012), available at http://commission.abi.org/sites/default/files/statements/26oct2012/NCBJ_field_hearing_transcript.docx (discussing the constitutional implications of restricting secured creditors' rights); *Statement of Danielle Spinelli: TMA Field Hearing Before the ABI Comm'n To Study the Reform of Chapter 11* (Nov. 3, 2012), available at http://commission. abi.org/sites/default/files/statements/03nov2012/Spinelli_ABI_Commission_Testimony_110312.pdf (responding to proposals to curtail secured creditors' credit-bidding rights).

7 *See Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n To Study the Reform of Chapter 11*, Exhibit B (Nov. 30, 2012), available at http://commission.abi.org/sites/default/files/statements/30nov2012/M_Shapiro_ABI_ Supplemental_Testimony_May_20_2013_2.docx.

8 Report at 12.

9 *Id.* at 15.

10 *See id.* at 3, 8-13.

11 *Id.* at 67-73.

12 *Id.* at 207-24.

13 *See id.* at 73-83 (recommending, among other things, barring certain roll-ups of prepetition debt and restricting courts' ability to approve milestones, benchmarks and similar provisions in DIP loans); *id.* at 83-87 (recommending 60-day moratorium on § 363 sales at beginning of case).

14 *See id.* at 296-98.

15 *Id.* at 234-37.

credit-bidding.[16] These recommendations address issues of importance to secured creditors that are currently the subject of disagreement in the courts.

As one might expect of a report issued by a well-respected group of leading bankruptcy professionals, the Commission's Report has received a great deal of attention. In the months since the Report's issuance, much has already been said and written about it. The Report has been the subject of scores of law firm client alerts. Unsurprisingly, the Report was the subject of extensive discussion at the ABI's annual conference earlier this year. Both the American College of Bankruptcy and the National Bankruptcy Conference have held conferences dedicated to consideration of the reforms proposed in the Report. It is anticipated that Congress will ultimately hold hearings focused on the Report's principal recommendations.

In advance of those hearings, and in the interest of promoting a robust debate about the proper functioning of the bankruptcy system and its role in the broader economy, the LSTA offers this Response. The Response is focused primarily on those recommendations of the ABI Commission that relate to the treatment of secured credit in bankruptcy, as well as its recommendations for SMEs.[17]

For the reasons discussed in detail below, LSTA believes that the Report's overall approach to reforming the Bankruptcy Code, while well-intentioned and informed by much hard work and debate, is misguided. Although some of its proposals are helpful, on balance, the changes to creditors' rights that the Report recommends are likely to do more harm than good to debtors, creditors, and credit markets alike. If adopted, these reforms risk disrupting the operation of a bankruptcy system that has served the nation very well—aiding in the economic recovery from the Great Recession—and that has become the envy of the world. They also threaten to increase the cost of credit to both performing and distressed businesses, which will in turn hurt the very businesses that the proposals are designed to help.

Part I of this Response briefly summarizes the main themes and key proposals of the Commission's Report as they relate to the treatment of secured credit and to SMEs. Part II examines what we see as the flaws in the Commission's overall approach to bankruptcy reform. Specifically, Part II.A examines the lack of empirical evidence showing that reform is necessary; Part II.B examines the potential costs of the Commission's proposals to the efficiency of the bankruptcy process and to the broader credit markets; and Part II.C examines the harm that could be created by the Commission's decision to cast aside basic principles of bankruptcy law, including the absolute priority rule and the principle that chapter 11 should maximize value for the creditors as a group. Part III then examines the Commission's most significant proposals affecting secured credit in detail. Part III.A discusses adequate protection; Part III.B discusses the "equities of the case" exception to the rule that secured creditors are entitled to postpetition proceeds of their collateral; Part III.C discusses surcharges of a secured creditor's collateral; Part III.D discusses sales of substantially all of a debtor's assets under § 363 of the Bankruptcy Code; Part III.E discusses debtor-in-possession financing; Part III.F discusses the Commission's "redemption option value" proposal; Part III.G discusses voting and classification of claims; Part III.H discusses SMEs; and Part III.I discusses three of the Commission's proposals with which LSTA agrees, regarding credit-bidding, the proper rate of interest on a secured claim under a cramdown plan, and the new-value corollary to the absolute priority rule.

I. THE COMMISSION'S REPORT

A. The Commission's View of the Need for Reform

The premise of the Commission's Report is that, since 1978, when the current Bankruptcy Code was enacted, the world has changed and chapter 11 has not kept up. Specifically, the Commission points to the greater use of secured credit and the resulting increase in the leverage of companies entering bankruptcy, the development of sizeable markets in distressed debt, including claims in bankruptcy, and the increasing complexity of companies' capital structures. Describing the "[n]eed for [r]eform," the Report explains:

> [T]oday's financial markets, credit and derivative products, and corporate structures are very different than those existing in 1978…. Companies' capital structures are more complex and rely more

[16] *Id.* at 146-47.

[17] The Commission's Report also addresses an array of other subjects that are worthy of discussion, but are beyond the scope of this Response.

> heavily on leverage, which is secured under state enactments of the Uniform Commercial Code that encumber vastly more assets than in 1978; their asset values are driven less by hard assets … and more by services, contracts, intellectual property, and other intangible assets; and both their internal business structures … and external business models are increasingly multinational. In addition, claims trading and derivative products have changed the composition of creditor classes. …. [T]he Bankruptcy Code was not originally designed to rehabilitate companies efficaciously in this complex environment.[18]

The Report notes that witnesses at the Commission's field hearings testified that, as a result of the evolution of the broader financial markets, "chapter 11 cases have changed over time."[19] It points to "(1) a perceived increase in the number and speed of asset sales under section 363 of the Bankruptcy Code; (2) a perceived decrease in stand-alone reorganizations; (3) a perceived decrease in recoveries to unsecured creditors; and (4) a perceived increase in the costs associated with chapter 11."[20] The Report states that "anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and medium-sized enterprises)."[21]

Moreover, the Report notes, "anecdotal evidence suggests that chapter 11 … is no longer capable of achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases …, or helping to rehabilitate viable companies."[22] "Some professionals suggest that more companies are liquidating or simply closing their doors without trying to rehabilitate under the federal bankruptcy laws," as well as "waiting too long to invoke" bankruptcy, which "may lead to premature sales or liquidations."[23]

Perhaps the most significant change the Report identifies since the enactment of the 1978 Code is "the perceived increase in senior [secured] creditor control in chapter 11 cases."[24] The Report notes that certain witnesses "posited that chapter 11 cases were being run for the benefit of the senior creditors and generating little, if any, value for other creditors."[25] The Report suggests that increased secured creditor control has led to fewer traditional reorganizations, more and quicker § 363 sales of debtors' assets, and reduced recoveries for constituencies other than senior secured debt.[26] The result, at least in some cases, is what the Commission views as a "subjectively unfair" allocation of too much value to senior secured creditors.[27]

The Commission therefore sought in its recommendations to "balance" the "rights of senior creditors" against "the reorganization needs of the debtor and the interests of other stakeholders."[28] Among its overarching goals, the Commission included "providing debtors more flexibility in arranging debtor in possession financing, clarifying lenders' rights in the chapter 11 case, … and providing a true breathing spell at the beginning of the case during which the debtor and its stakeholders can assess the situation and the restructuring alternatives," as well as "incorporat[ing] checks and balances on the rights and remedies of the debtor and of creditors, including through valuation concepts that potentially enhance a debtor's liquidity during the case."[29]

A. The Commission's Proposals

To further those goals and to redress what it views as the misaligned "balance" between secured creditors' rights and those of other constituencies, the Report makes a number of specific proposals to modify secured

[18] Report at 12.

[19] *Id.* at 15.

[20] *Id.*

[21] *Id.* at 12.

[22] *Id.*

[23] *Id.*

[24] *Id.* at 214.

[25] *Id.* at 215 & n.784.

[26] *See, e.g.*, *id.* at 87 (contending that § 363 sales "are proceeding more quickly than is necessary in many chapter 11 cases," "reduc[ing] the value available for stakeholders"); *id.* at 216 (noting testimony that "capital structures overwhelmed by secured debt … are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales").

[27] *Id.* at 207.

[28] *Id.* at 214.

[29] *Id.* at 6.

creditors' existing rights in chapter 11. Perhaps the five most important proposals involve adequate protection of secured creditors' collateral; restrictions on § 363 sales; restrictions on the terms of DIP financing; modification of the absolute priority rule; and small and medium-size enterprises. For the purpose of providing an overview of the Commission's approach, these five key proposals are summarized here; the proposals, along with a number of others, are described in more detail in Part III.

1. Adequate Protection

One of the Report's key proposals is to limit the amount of "adequate protection" a secured creditor is entitled to receive against depreciation in the value of its collateral during the bankruptcy case.[30] Adequate protection is designed to ensure that a secured creditor receives at least the full value of its collateral as of the petition date. Where a senior secured creditor holds a blanket lien on substantially all of the debtor's assets—which is not uncommon—the value of the creditor's collateral is essentially the going-concern value of the enterprise.

The Report recognizes that secured creditors are entitled to the going-concern value of their collateral under a plan of reorganization or in a sale under § 363 of the Bankruptcy Code.[31] The Report posits, however, that "[t]he use of a going concern valuation" for adequate protection purposes "may … reduc[e] significantly the debtor's financing and reorganization options."[32] It proposes that secured creditors receive adequate protection based on the "foreclosure value" of their collateral rather than the collateral's value as part of a going concern. "Foreclosure value" is defined as the value a secured creditor would receive "upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law"—but without taking into account the secured creditor's right to credit-bid at such a sale.[33] The Report further proposes that, if there is a difference between the value collateral would realize at such a foreclosure sale and the value it would realize at a sale under § 363 of the Bankruptcy Code, that "cushion" can constitute adequate protection.[34]

2. Section 363 Sales

The Commission recommends imposing a moratorium of 60 days after the petition date on § 363 sales of substantially all of the debtor's assets.[35] Sales could be conducted during this period only if the sale proponent demonstrates by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease substantially during the 60-day period.[36] In addition, the Report recommends permitting a court to approve a sale of substantially all of the debtor's assets only if it finds that the sale is in the best interests of the estate and complies with many of the same requirements as confirmation of a chapter 11 plan, including that administrative claims be paid in full out of the sale proceeds.[37]

3. DIP Financing

The Commission proposes to restrict the permissible terms of DIP financing agreements. Among other things, the Commission proposes to limit "roll-up" provisions, which provide for payment of prepetition debts with the proceeds of a postpetition DIP facility.[38] The Report would also forbid "milestones, benchmarks, or other provisions that require the trustee [or debtor] to perform certain tasks or satisfy certain conditions," such as conducting an auction or closing a sale, during the first 60 days of the case.[39] In addition, the Report would bar waivers of the provisions of § 506(c), which allows a DIP or trustee to surcharge a lender's collateral if the estate incurs expenses to preserve the collateral, and § 552(b), which provides that, based on the "equities of the case," a court may limit

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[30] *See* 11 U.S.C. §§ 361-364.

[31] Report at 72.

[32] *Id.* at 71.

[33] *Id.* at 67.

[34] *Id.* at 67-68.

[35] *Id.* at 83.

[36] *Id.*

[37] *Id.* at 201.

[38] *Id.* at 73.

[39] *Id.* at 73, 79-80.

the extent to which a creditor's prepetition lien on collateral reaches postpetition proceeds of that collateral.[40] The Report also proposes to restrict liens on, or interests in, avoidance actions or their proceeds.[41] Interim financing orders would be even more strictly limited.[42]

4. Redemption Option Value

Under existing law, distributions to nonconsenting creditors in chapter 11 cases must follow the rule of absolute priority: Senior creditors are paid before junior creditors, who are paid before equity-holders. The Report recommends breaking from the absolute priority rule in certain large chapter 11 cases and requiring senior creditors in those cases to relinquish part of their recovery to junior creditors.[43]

Specifically, the Report proposes that otherwise out-of-the-money junior creditors should be entitled to receive compensation for the "option value" of their claims—the possibility that, had the enterprise been valued at some later date, it would have been worth more, and the junior creditors would have been in the money. The Report notes that a firm's valuation in bankruptcy "may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair."[44] Accordingly, the Report recommends that an undersecured senior secured creditor receiving a distribution under a sale or plan be required to share its recovery with the immediately junior class of creditors, as long as that class has not objected to the sale or the plan's valuation of the reorganized firm.[45]

The junior creditors would be entitled to receive what the Report calls the "redemption option value" of their claims, defined as the value of a hypothetical option to buy the firm, expiring on the third anniversary of the petition date, and priced at the full face amount of the senior class's claim plus interest at the non-default contract rate and allowable fees and expenses. The bankruptcy court would determine the redemption option value at the confirmation or sale hearing, based on the Black-Scholes option pricing model or a similar methodology.[46]

5. Small and Medium-Sized Enterprises

The report proposes an ambitious new scheme for bankruptcies of small and medium-sized enterprises (SMEs) that would differ substantially from current chapter 11. An SME is defined as a nonpublic company with less than $10 million in assets or liabilities; however, nonpublic companies with up to $50 million in assets or liabilities could request SME treatment.[47] The major change in the treatment of SMEs would be that, even if creditors are not paid in full, the prepetition owners of an SME would be entitled to keep 100% of the common stock of the company (and thus control over the company), along with 15% of the economic distributions from the business, for four years after bankruptcy.[48] Nonconsenting secured creditors would be treated according to the existing cramdown provisions of chapter 11, except that they would not be allowed to elect to have their entire claim treated as secured under § 1111(b) of the Bankruptcy Code.[49] Unsecured creditors would be entitled to receive only preferred stock with no meaningful voting rights, together with 85% of the economic distributions from the business; unless redeemed earlier, the stock would convert into 85% of the common stock of the business four years after the bankruptcy.[50]

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[40] *Id.* at 226.

[41] *Id.* at 73.

[42] *Id.* at 80.

[43] *Id.* at 207-11.

[44] *Id.* at 207.

[45] *Id.* at 207-09.

[46] *Id.* at 209-10.

[47] *Id.* at 279.

[48] *Id.* at 297.

[49] *Id.* at 296.

[50] *Id.* at 296-98.

II. THE FLAWS IN THE REPORT'S APPROACH

Before turning to a detailed discussion of the Commission's specific proposals, we want to examine the Commission's basic approach to the question of bankruptcy reform. We believe that approach is flawed in several ways, both practical and theoretical.

*First***,** as discussed above, the Commission's specific recommendations are premised on a particular narrative whose central plot-line is that the evolution of the financial markets, including the increased use of secured credit, has fundamentally changed the bankruptcy process, rendering the existing Code outdated. As the Commission notes, that narrative is accepted by many; it was reflected in the testimony of multiple witnesses and has been endorsed by a number of academics. But the Commission offers no reliable empirical evidence that increased secured creditor control has actually undermined the effectiveness of the Bankruptcy Code. Instead, by its own admission, it relies on "anecdote" and "perception" for that point. But anecdote and perception—even if widely shared—should not be a sufficient basis for proposing dramatic changes to existing law. In the absence of reliable data demonstrating that a problem actually exists, we should hesitate before trying to fix the "problem."

Indeed, although more research is desirable, recent studies on this question have not found that secured creditor control has led to an increase in liquidations of companies that should have been reorganized or to a loss of value that could have been realized for junior creditors. To the contrary, there is evidence that chapter 11 has adapted very well to today's world. A recent article by Stuart Gilson of the Harvard Business School, for example, explains that the bankruptcy system played a critical role in supporting the U.S. economy's rebound from the effects of the financial crisis.[51] Two other studies that looked specifically at the question whether secured creditor control leads to value-reducing liquidations of otherwise viable businesses found that it does not.[52] And Jay Westbrook's recent analysis of a full range of chapter 11 cases, from small to mega-sized, similarly found that "the conventional picture of secured creditor control and 363 sales is misleading and overstated."[53] As Westbrook put it, "[t]he idea that important recommendations will be made by the American Bankruptcy Institute Commission without hard data on the role of secured credit is problematic to say the least and might lead to wrongheaded reform."[54]

*Second***,** there is substantial reason to believe that the Commission's proposed reforms would make the bankruptcy process more complex and expensive and could have harmful real-world consequences. Despite the Commission's assertion that its proposals are designed to reduce the cost of bankruptcy, there can be little doubt that their effect would be to make many cases longer, and therefore costlier. Indeed, the very purpose of certain proposals, like the 60-day moratorium on § 363 sales, is to make cases longer. Other proposals would also make cases longer; for instance, limiting a secured creditor to adequate protection of only the foreclosure value of its collateral is intended to permit the debtor to use or borrow against the remainder of the collateral and thus potentially finance a longer stay in bankruptcy. Still other changes would add complexity, and therefore cost, to the bankruptcy process. The Commission's proposal contemplates several different types of judicial valuations—each requiring different and undoubtedly costly document discovery, accounting, and outside expert analysis—conducted for different purposes at different points in the case. The determination of redemption option value, for example, involves complex option value modeling that would add substantial time and expense to the bankruptcy process. Even the SME proposals, which apply in the cases in which the cost of chapter 11 is most likely to hinder its objectives, would add complexity rather than simplify the process.

In addition, the Commission does not appear to have given adequate consideration to the effect its proposals would have on the operation of markets outside of bankruptcy. The bankruptcy system, of course, does not exist in a vacuum. Rather, the results of the bankruptcy process—what lenders can expect to recover in the event a borrower ends up in bankruptcy—will necessarily affect the way lenders think about extending credit in the first instance. And giving a debtor greater ability to use a secured creditor's collateral in the manner it sees fit necessarily means imposing greater risk and cost on the secured creditor. Doing so will have consequences. As the ratings

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[51] Stuart C. Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping To Revive the U.S. Economy*, 24 J. App. Corp. Fin. 23, 23-24, 25 (2012).

[52] Mark Jenkins & David Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization* 4, 26 (working paper 2014), available at http://ssrn.com/abstract=2444700 (finding that inefficient liquidations are uncommon); Stuart Gilson, Edith Hotchkiss & Matthew Osborn, *Cashing Out: The Rise of M&A in Bankruptcy* 31(working paper 2015), available at http://ssrn.com/abstract=2547168

[53] Jay Lawrence Westbrook, *Secured Creditor Control and Bankruptcy Sales: An Empirical View*, 2015 U. Ill. L. Rev. 831, 831.

[54] *Id.* at 845.

agency Fitch noted, changes like those the Commission has proposed will decrease lenders' recoveries in the event of default.[55] They will therefore increase the cost and reduce the availability of credit to all companies—some of which rely on the availability of that credit to stay out of bankruptcy in the first instance. In addition, the experience of other nations that have experimented with reforms similar to those the Commission proposes demonstrates that this concern is far from theoretical.[56] Their experience is precisely what one would expect: When insolvency regimes make credit riskier for lenders, credit becomes more expensive and more difficult to obtain. Nothing in the Report addresses, let alone provides any comfort regarding, the consequences of its proposed reforms on the broader credit markets.

*Third***,** although the Commission conducted an admirably thorough review of the literature and the views of a variety of constituencies, and put a great deal of thoughtful effort into its proposals, in our view, the Report's overall approach is analytically flawed. The existing Bankruptcy Code is built on a simple conceptual foundation. Its central goal is to maximize the value of the enterprise, and to distribute that value—with a handful of exceptions—in accordance with the parties' nonbankruptcy priorities. Bankruptcy law in its current form does not attempt to impose its own vision of substantive fairness by altering the distributional scheme nonbankruptcy law creates. In particular, chapter 11 is carefully designed to protect a secured creditor's nonbankruptcy right to first priority in all proceeds realized from its collateral until it is paid in full. It does so through a series of interlocking provisions, including the right to adequate protection, the right to credit-bid in a sale of one's collateral, the right to be treated as fully secured, and the existing cramdown provisions, which incorporate the absolute priority rule. Likewise, chapter 11 holds firm to the basic rule, which reflects nonbankruptcy law, that creditors recover before equity-holders.

The Report's proposals are based on the view that those principles now produce outcomes that are "subjectively unfair" and "unbalanced." In response, the Report seeks to "re-balance" the parties' rights by scaling back chapter 11's existing protections for secured creditors in a number of important ways, while making other proposals that would benefit secured creditors. At the end of the day, that approach has led to a Report that suffers from the same problem as most products that result from compromise among representatives of diverse constituencies. Despite the Commission's unquestioned good faith and hard work, its Report does not articulate clear and understandable first principles of bankruptcy law and then implement those principles. Rather, it trades off rights among competing constituencies to achieve a result that the Commission views as "fair." The loser in that tradeoff, however, is the internal coherence and careful architecture of existing bankruptcy law.

A. Empirical Evidence Does Not Support a Need for Reform

The premise of the Report—indeed, its reason for being—is that the financial markets, and bankruptcy practice, have changed dramatically since Congress enacted the Bankruptcy Code in 1978, and the Code has not kept up. The result, according to the Commission, is that chapter 11 no longer adequately serves the aims for which it was designed. Specifically, increased secured creditor control has led to more and faster sales under § 363; fewer traditional reorganizations; and a decrease in unsecured creditor recoveries. In addition, the application of the absolute priority rule to bar business owners from keeping control of their companies when creditors are not paid in full, and the rising cost of chapter 11, have increasingly shut small and medium-sized enterprises out of the process.

There can be no question that chapter 11 practice—and the world as a whole—has changed a great deal since 1978. However, the popular narrative, in which secured creditors have nearly total control over the chapter 11 process and companies are sold cheap while debtors have no opportunity to reorganize, is significantly exaggerated. Moreover, many of the changes that the Report identifies as having hurt the efficacy of the chapter 11 process have in fact had some beneficial results. In many respects, chapter 11 has successfully adapted to today's world and continues to work as well as, if not better than, in the past. Most importantly, reliable empirical evidence does not support the Report's view that increased secured creditor control has damaged the chapter 11 process. Likewise, no reliable data demonstrate that the Report's proposed reforms are needed to redress the perceived injury. And in the absence of such evidence, there is no justification for the drastic changes the Report proposes.

[55] FitchRatings, *Fitch: Proposed Changes to Chapter 11 Could Pressure First Lien Recoveries if Adopted* (Dec. 9, 2014), available at https://www.fitchratings.com/site/fitch-home/pressrelease? id=946215.

[56] See infra Part II.B.2 .

1. Bankruptcy Practice, Then and Now

The modern era of bankruptcy law in the United States begins with the adoption of the Bankruptcy Code in 1978. For some, the first few decades under the new Bankruptcy Code represented a "golden age of debtor rehabilitation"[57]—an era in which bankruptcy practice flourished, as debtors and lenders sat across the table from each other as partners to work out consensual, mutually beneficial deals that kept debtors alive.[58]

On this account, a successful chapter 11 case in the early days of the Bankruptcy Code was one that resulted in a stand-alone reorganization.[59] Lenders usually went into bankruptcy expecting this outcome. The debtor's key creditors were usually the banks who had originated the loans in the first instance, had kept the debtor's loans on their books, and were disposed to negotiate with the debtor toward its reorganization, in the hope of doing future business with it.[60] Unsecured creditors also generally supported the goal of a reorganization. Speedy liquidation of claims through trading was uncommon.[61] Junior creditors had little option but to participate in the reorganization process. Reorganization also benefited them by preserving business relationships which might, by themselves, have significant value.[62] And unsecured creditors could be significant players in the bankruptcy—trade debt and other unsecured debt formed a major portion of most debtors' liabilities, and unsecured creditors were often the fulcrum class (that is, the most junior class with any recovery).[63] The Code was structured to permit these parties to negotiate toward a consensual plan.

Yet, properly analyzed, the golden age of bankruptcy loses much of its luster. Too frequently, the Bankruptcy Code in its adolescence gave rise to bankruptcies that were slow, expensive, and inefficient. Even though the debtors of the 1980s and 1990s frequently had capital structures far less complex than in today's marketplace,[64] bankruptcy cases were time-consuming[65]—and thus costly for creditors.[66] During bankruptcy the debtor also

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[57] Harvey Miller, *Chapter 11 in Transition: From Boom to Bust and Into the Future*, 81 Am. Bankr. L.J. 375, 386 (2007); *see also* Harvey Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960-2010)*, 19 Norton J. Bankr. L. & Prac. 3 Art. 1 (2010) (arguing that 1980 to 2000 was "the zenith of the age of the debtor").

[58] *See Written Statement of Bettina M. Whyte: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2012), available at http://commission.abi.org/sites/default/files/sbtements/whytestatement.pdf ("Banks . . . were driven by long term relationships with their borrowers. . . In other words, they had a vested interest in seeing that a debtor restructured. . . The lenders, while international banks, were still part of the community and saw their own reputations at stake, not just the Debtor's . . . . [Unsecured creditors] were parties who needed the Debtor to survive long term.").

[59] Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129, 146 (2005) (arguing that the Code was interpreted in its early years to "meet the needs of the Congressional policy of furthering rehabilitation"); *see also* Miller 2007, *supra* note 57, at 387 (noting perception among creditors that chapter 11 meant "reorganization über alles").

[60] Whyte, *supra* note 58; Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain A Viable Option?*, 78 Am. Bankr. L. Rev. 153, 181-82 (2004) (noting that creditor financial institutions were previously more influenced by relationships with management than today); Harvey Miller, *Chapter 11 Reorganization Cases and the Delaware Myth*, 66 Vand. L. Rev. 1987, 2015 (2002).

[61] Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11*, Am. Bankr. Inst. J. 1, 62 (July 2010) (discussing evolution of modern claims trading market following liberalization of claims trading rules in 1991); Whyte, *supra* note 58 ("Twenty years ago, the practice of debt trading did not exist."). Some view creditors' inability to exit bankruptcy as an advantage, driving the core mechanics that made chapter 11 successful, and lament the effect of the options creditors now have. *See* Miller 2002, *supra* note 60, at 2014 ("Distressed debt trading and changes in bankruptcy relationships have destroyed the symbiotic relationship of debtor and creditor.").

[62] Miller & Waisman, *supra* note 59, at 181.

[63] Kenneth N. Klee & Richard Levin, *Rethinking Chapter 11*, 21 Norton J. Bankr. L. & Prac. 465, 465, 480 (2012) (noting that "[t]rade debt was a significantly larger portion of a distressed debtor's liabilities compared to bank or bond debt" and that "[t]he Bankruptcy Code was … written at a time when unsecured debt was the fulcrum security in the typical case"). The fulcrum security holder is in effect the residual owner of the company. *See* Michelle Harner, *Activist Distressed Debtholders: The New Barbarians At the Gate?*, 89 Wash. U. L. Rev. 155, 161 (2011).

[64] *See, e.g.*, Frank Partnoy, *Twenty Years of Change: Financial Innovation in Corporate Law*, 31 Iowa J. Corp. L. 799, 799-800 (2006) (explaining that the capital structures of the 1980s were "relatively straightforward").

[65] *See* Charles J. Tabb, *Chapter 11 Issues: The Future of Chapter 11*, 44 S.C. L. Rev. 791, 822 (1993) ("One of the predominant criticisms of Chapter 11 is that it takes too long."); Stephen P. Ferris & Robert M. Lawless, *The Expenses of Financial Distress: The Direct Costs of Chapter 11*, 61 U. Pitt. L. Rev. 629, 637 (2000) (finding the mean length of a chapter 11 case begun between 1986 and 1993 to be 437 days); Samuel L. Bufford, *Chapter 11 Case Management and Delay Reduction: An Empirical Study*, 4 Am. Bankr. Inst. L. Rev. 85, 85 (1996) ("[T]he recent nine-month O.J. Simpson trial was short compared to the careers of some chapter 11 bankruptcy cases.").

[66] *See* Bufford, *supra* note 65, at 90 ("Creditors suffer the expenses and losses resulting from delay in a chapter 11 case"); Ferris & Lawless, *supra* note 65, at 637 ("Because most creditors do not receive postpetition interest for their debt, creditors' claims become less valuable with

accrued significant costs—not only direct costs, consisting of large professional fees paid to legal and financial practitioners tasked with moving the bankruptcy process forward,[67] but also indirect costs.[68] Chapter 11 might cause suppliers and customers to be unwilling to do business with a distressed firm,[69] draining the firm's value the longer it stayed in bankruptcy. Nonetheless, the debtor-in-possession largely retained control over the pace of the case.[70] Creditors might lack the leverage to force a speedy resolution on a dilatory debtor, and might be equally constrained in their ability to influence the business operations of the debtor firm so long as it remained mired in chapter 11.[71]

In sum, while bankruptcy practice in the early years of the Code valorized consensus and negotiation in pursuit of a mutually beneficial reorganization, that process had significant costs. Bankruptcy was frequently slow and inefficient. The end result was ideal neither for debtors, subject to high direct and indirect costs, nor for creditors, who were subjected to the uncertainty of a drawn-out chapter 11 process, with only a limited ability to control or influence that process. The work this system generated for professionals, however, in contrast to work under the pre-1978 Bankruptcy Act, became both lucrative and prestigious.[72]

Today, by contrast, the bankruptcy process plays out from start to finish against the backdrop of developed, sophisticated, and efficient markets. In particular, non-investment-grade firms now have access to a broad leveraged lending market, offering historically unprecedented opportunities to raise capital.[73] This increased leverage stems, in part, from more liberal rules governing which assets a company can collateralize. Specifically, in 1999, Article 9 of the Uniform Commercial Code was revised to permit borrowers to grant security interests in substantially all of their assets, both tangible and intangible.[74] The revised Article 9 also made it substantially easier for a lender to perfect a blanket lien on a borrower's assets by adopting uniform national forms for financing statements that could be filed in a single location and permitting financing statements to use plain-English descriptions of collateral, including generic descriptions such as "all of the borrower's assets."[75] The practical ability to obtain enforceable blanket liens on a borrower's assets in turn spurred the development of a robust leveraged lending market, as it made loans to non-investment-grade or distressed borrowers less risky.[76]

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each passing day.").

[67] Gilson 2012, *supra* note 51, at 26; Bufford, *supra* note 65, at 92 ("In cases that last longer, professionals tend to put in more time, and thus generate more fees, even though the results may be essentially the same.")*but see* Stephen J. Lubben, *What We Know About Chapter 11 Costs Is Wrong*, 17 Fordham J. Corp. & Fin. 141, 184 (2012) (arguing that long chapter 11 cases do not generally involve higher costs).

[68] Gilson 2012, *supra* note 51, at 26; Bufford, *supra* note 65, at 92.

[69] Bufford, *supra* note 65, at 92 (describing the indirect costs of bankruptcy).

[70] Miller 2007, *supra* note 57, at 387 ("[T]he debtor/debtor in possession did become the leading actor in the chapter 11 reorganization scenario during the 1980s"); Whyte, *supra* note 58 ("In Fairchild's bankruptcy, the Debtor had an unlimited amount of time to determine how to best restructure its business operations.").

[71] *See* Ferris & Lawless, *supra* note 65, at 637 ("Delay often works to the advantage of owners and management who use delay as bargaining leverage with creditors. In exchange for expediting the case, owners and managers can extract valuable concessions from creditors.").

[72] *See, e.g.*, Todd Zywicki, *Review: Rescuing Business*, 16 Bank. Dev. J. 361, 376 (2000) ("[U]nder the 1978 Code, bankruptcy has become an increasingly lucrative and prestigious practice area…. The prestige and financial benefits are a direct result of the policies brought into play by the 1978 Code."); Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11*, 5 J. Bus. & Tech. L. 263, 266 (2010) (discussing high levels of fees in chapter 11 cases and noting the difficulty of limiting professional fees in chapter 11).

[73] *See, e.g.*, Miller 2007, *supra* note 57, at 378-81 (describing increase in business leverage levels).

[74] *See* Uniform Commercial Code, Art. 9; Uniform Law Commission, *UCC Article 9, Secured Transactions (1998) Summary*, available at http://www.uniformlaws.org/ActSummary.aspx?title=UCC% 20Article%209,%20Secured%20Transactions%20 (1998). Revised Article 9 has been adopted in all 50 states and the District of Columbia. *See* Uniform Law Commission, *Guide to Uniform and Model Acts* 10 (2014), available at www.uniformlaws.org/Shared/Publications/GUMA_2014web.pdf.

[75] *See, e.g.*, Elaine A. Welle, *An Introduction to Revised Article 9 of the Uniform Commercial Code*, 1 Wyo. L. Rev. 555, 568, 570 (2001).

[76] Miller 2007, *supra* note 57, at 378-381 (commenting on growth of various leveraged lending markets); Steve Trollope, *Leveraged Loans Should Be Lauded, Not Maligned*, Forbes, Sept. 26, 2014, available at http://www.forbes.com/sites/realspin/2014/09/26/leveraged-loans-should-be-lauded-not-maligned/; William Mann, *Creditor Rights and Innovation: Evidence from Patent Collateral* (working paper Apr. 27, 2015), available at http://ssrn.com/abstract=2356015 (finding that both small and large firms were able to borrow to fund research and development as states adopted revised Article 9 and courts made clear that the federal patent system did not preempt creditor-friendly state laws); Maria Loumioti, *The Use of Intangible Assets as Loan Collateral* (working paper Nov.1,2012) finding that collateralizing loans by intangibles significantly increases credit supply to firms), available at http://ssrn.com/abstract=1748675; Claire A. Hill, *Is Secured Debt Efficient?*, 80 Tex. L. Rev. 1117, 1146, 1176 (2002) ("Of the firms whose ratings profiles were included on the Standard & Poor's website and Standard & Poor's Global High Yield Report, no firms above BB+ had blanket liens, most firms below BB+ did, and all firms below BB-did.").

At the same time, a robust market has also developed in high-yield bonds, allowing non-investment-grade companies to obtain greater access to capital, made available by sophisticated creditors who understand the credit risk associated with their investments. The upshot is that debtors today, compared to debtors from the 1980s, are likely to have more intricate capital structures reflecting the complexity of today's financial markets and the products they offer.[77] The average debtor holds more secured debt than a debtor in the early days of the Code.[78] And the fulcrum security in a bankruptcy case is now more likely than in the past to be a secured creditor class.

Markets have also made the bankruptcy process more fluid. The growth of enormous and active markets for distressed debt[79] means that debtors will often be dealing with distressed debt investors who have purchased the debtor's loans to realize the maximum possible return on an investment.[80] These investors are often repeat players in bankruptcy with substantial experience shepherding distressed companies through the bankruptcy process.[81] Their resources and experience may prove valuable to such a company—although distressed debt investors may also be sophisticated and aggressive in enforcing their rights.[82]

Unsecured creditors have also changed. Where previously unsecured creditors were more likely to be the trade creditors and suppliers who originally extended credit to the debtor and may thus have had a stake in an ongoing business relationship, unsecured creditors are now able to exit the bankruptcy process quickly and easily by selling their claims to investors—a practice virtually unheard of in the early days of the Bankruptcy Code.[83] These investors may hope to realize short-term profit by collecting on the claim, may be seeking greater ability to monitor or otherwise influence the debtor during the bankruptcy process, or may hope to streamline the bankruptcy negotiations by consolidating the debtors' stakeholders.[84] Any of these motivations may present a debtor with a negotiating partner whose interests differ significantly from those of the unsecured creditors debtors encountered in the earlier days of the Code.

Debtors typically now no longer have the kind of leverage that would permit a leisurely chapter 11 case. Just as prepetition creditors may strictly enforce their rights, postpetition DIP lenders may pressure debtors to resolve their case quickly. DIP lending has become the focus of a specialized market,[85] and the sophisticated institutional lenders who offer DIP loans have developed a wide variety of loan terms reflecting the riskiness of the debtors to which they lend.[86] For example, DIP lenders may negotiate for milestones requiring the debtor to file a plan or perform other actions by certain specified dates.[87]

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[77] Partnoy, *supra* note 64, at 799-800 (capital structures, once relatively straightforward, are now more complex); *see also* Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 Dick. L. Rev. 267, 287 (2001) (describing a typical capitalization structure).

[78] Report at 12 (citing Mark Jenkins & David C. Smith, *Creditor Conflict and the Efficiency of Corporate Representation* 2-3 (working paper 2014)).

[79] *See* Gilson 2012, *supra* note 51, at 24-25; Edward I. Altman, *The Role of Distressed Debt Markets, Hedge Funds, and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 Am. Bankr. Inst. L. Rev. 75, 75-85 (2014).

[80] Michelle M. Harner, *The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing*, 77 Fordham L. Rev. 703, 714-18 (2009) (discussing types of distressed debt investors).

[81] Gilson 2012, *supra* note 51, at 24; *see also* Edith Hotchkiss & Robert M. Mooradian, *Vulture investors and the market for control of distressed firms*, 43J.Fin.Econ. 401 (1977) (finding that distressed-debt investors add value by disciplining managers of distressed firms).

[82] *See, e.g.*, Miller 2007, *supra* note 57, at 389-95 (criticizing "hedge fund" investors in bankruptcy); Altman, *supra* note 79, at 85-88 (describing split in the academic literature over the effect of distressed debt investing).

[83] *See* Hammer & Brandess, *supra* note 61, at 1; Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67, 73 (2009) (discussing arguments in favor of claims trading).

[84] Levitin, *supra* note 83, at 73-74.

[85] Gilson 2012, *supra* note 51, at 28.

[86] Elliot Ganz & Allison Hester-Haddad, *DIP Loans: A Common-Sense Assessment of Extraordinary Provisions*, Secured Lender 32, 33-34 (Oct. 1, 2013).

[87] Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 2 J. Legal Analysis 511, 514 (2009); Gilson et al. 2015, *supra* note 52, at 17-18; *Written Statement of Mark Shapiro: Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 30, 2012) (on file with LSTA) (describing LSTA's study of DIP lending).

Bankruptcy cases are resolved more quickly for other reasons as well. Chapter 11 cases today are more likely to be resolved through a § 363 sale of substantially all the debtor's assets than in the early years of the Code.[88] While § 363 has always permitted debtors to sell assets, debtors have increasingly filed for bankruptcy with a view to selling all of their assets through § 363 rather than intending a traditional reorganization. Such sales can close much more quickly than a traditional reorganization, thereby minimizing the costs of bankruptcy. Just like a traditional reorganization, however, a § 363 sale is capable of preserving a business as a going concern.[89] and can realize as much value for stakeholders as a traditional reorganization.[90]

In short, since 1978, bankruptcy cases have evolved. They have become faster. Indeed, as the Commission itself notes, the average time a large public or private company spends in chapter 11 has declined from nearly 1,000 days for 1989 filings to 116 days for 2013 filings.[91] Chapter 11 is no longer the preserve of a niche group of bankruptcy professionals, but rather the focus of sophisticated investors with extensive experience handling distressed debt and bankruptcy cases. Many of these new players approach bankruptcy with a different mindset than the old players in bankruptcy cases. These investors will commonly (although not always) seek to obtain the greatest returns by maximizing the going concern's value, but they are open to alternatives other than traditional reorganization that can achieve that end.[92]

Despite all of these changes, however, some things have not changed. A chapter 11 case still involves a negotiation among the interested parties, and senior secured creditors do not necessarily hold all the cards. As discussed below, in many cases there is no dominant secured creditor, or creditor with sufficient leverage to drive the bankruptcy process.[93] And even in cases where there is a dominant secured creditor, there are limits to its ability to direct the outcome of the bankruptcy case at the expense of other creditors. For one thing, existing law allows bankruptcy courts to prevent secured creditors from obtaining the benefit of chapter 11 while imposing the costs on other parties. In a case in which there truly are no unencumbered assets, bankruptcy courts can and do require the secured creditor to pay the administrative expenses of the case[94] or else face dismissal of the bankruptcy.[95] In addition, unsecured creditors can and do assert that some of the value of the company is outside the secured creditor's collateral base and that they are entitled to share in that value. Even in cases in which those arguments may lack merit, it is common to reach a consensual plan under which unsecured creditors receive some recovery.

2. Is There A Need For Reform?

Although the Commission admits that, in principle, none of the changes that have transformed bankruptcy are unhealthy developments,[96] it nonetheless believes that they require a rethinking of chapter 11.[97] Secured creditors, the Commission concludes, now have more control over the chapter 11 process than they should, resulting in liquidations or quick going-concern sales of companies that could and should have been reorganized. The Commission's solution is to reduce secured creditor control by placing more power in the hands of the debtor.

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88 Gilson et al. 2015, *supra* note 52, at 7-8; Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L.J. 862, 865-66, 877 n.54 (2014).

89 Gilson et al. 2015, *supra* note 52, at 31 ("M&A in bankruptcy often achieves a similar economic outcome when compared to a traditional reorganization.").

90 Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L. J. 591, 625-26 (2012) (arguing that creditors are generally able to ensure debtor is sold for fair value in a § 363 sale).

91 Report at 220-21.

92 *See* Hotchkiss & Mooradian, *supra* note 81, (describing strategies of distressed debt investors); Allison Hester-Haddad & Danielle D'Onfro, *Limiting the Background Noise: Investor Motivation and Identity in Bankruptcy*, 33 Am. Bankr. Inst. J. 38, 38, 107-09 (Dec. 2014).

93 Not every large secured creditor is a dominant creditor. For example, oversecured creditors who are likely to be paid in full regardless of what happens in the case often exercise little influence on the day-to-day bankruptcy proceedings. *See, e.g.*, Jenkins & Smith, *supra* note 52, at 13-14, 20.

94 11 U.S.C. § 506(c); *In re Foremost Mfg. Co.*, 137 F.3d 919, 923 (6th Cir. 2004) ("[T]he general rule in bankruptcy is that administrative expenses are paid only after secured creditors are. But to prevent secured creditors from, say, getting free warehousing for their collateral at the expense of the rest of the estate, courts can make the secured creditors contribute to cover those expenses."); *In re JKJ Chevrolet*, 26 F.3d 481, 483 (4th Cir. 1994) ("506(c) allows the trustee to recover administrative expenses from the collateral of a secured creditor to the extent that the expenditures benefit the secured creditor.").

95 11 U.S.C. § 1112(b)(4)(A), (M).

96 Report at 12.

97 *Id.*

There is a rational basis for the concern that secured creditor control could skew outcomes. The goal of the chapter 11 process is to maximize the value of the estate as a whole for the benefit of all stakeholders, not to maximize the recovery of any single constituency. But different constituencies in the chapter 11 process have different goals, and those goals are not always aligned with what is best for the estate as a whole.

In theory, in solvent firms outside bankruptcy, where the shareholders who will receive the benefits also bear the costs, management should make decisions whose expected benefits exceed the costs. But chapter 11 debtors present a special problem, because the constituencies who might ultimately benefit from a particular decision do not necessarily bear the cost of that decision. Take, for example, a company that faces a decision whether to invest $1 million to obtain a 60% chance of a $2 million return. Outside bankruptcy, a company would make that investment, because the expected return on the investment ($2,000,000 * .60 = $1.2 million) is more than its cost ($1 million).

The legitimate concern that underlies the worry about secured creditor control is the possibility that senior secured creditors are leading debtors-in-possession to pass up value-maximizing investments (and a decision to incur the expense associated with a bankruptcy reorganization—rather than sell the business—is, after all, a form of investment), because the secured creditors will incur the cost of failure, while the benefits of success will go to more junior creditors or equity holders.

Take, for example, a senior secured creditor, with a blanket lien on substantially all the assets of a company, who is close to fully secured (slightly oversecured or slightly undersecured). That secured creditor will have an incentive to push for quick realization of the value of its claim, to minimize the costs of the chapter 11 process.[98] Consider the example above, but for a company in bankruptcy whose assets are worth $800,000, with $1 million in secured debt and $2 million in unsecured debt. Viewed solely from the perspective of the secured creditor, the otherwise sensible investment of $1 million for a 60% chance at a $2 million return described above would be unwise. If the company is liquidated today, the secured creditor will recover 80 percent of its $1 million claim, or $800,000. For the secured creditor, the maximum potential return of the $1 million investment is $200,000, since it would receive $800,000 without making the investment and cannot recover more than its $1 million claim. But making that $1 million investment would leave it with a 40 percent chance of losing the $800,000 it would otherwise receive and recovering nothing—a risk it would not rationally choose to bear in order to obtain a 60 percent chance of receiving an additional $200,000.

Of course, the reverse concern is equally present. Otherwise out-of-the money creditors have an equal incentive to encourage unwise investments, because the costs of those investments are borne by senior creditors, while the more junior creditors will enjoy the potential upside. Take, for example, the same situation described above, but where the likelihood of the $2 million return on the $1 million investment is only 40%. While a solvent company outside of bankruptcy would not make such an investment, out-of-the-money unsecured creditors would choose to have the company do so. They have nothing to lose, because they would recover nothing if the company were sold as a going concern today, but would have a 40% chance of a $1 million recovery (after the secured creditor is paid in full) if the company chose to roll the dice.

In a perfectly functioning bankruptcy system, management of the debtor-in-possession would make decisions that were in the interest of the bankruptcy estate as a whole, without regard to which constituency would bear the risks or reap the benefits. So in deciding whether to sell the company today or undertake a lengthy and expensive bankruptcy process in the hope of generating greater value through a reorganization, the debtor's management *ought* to engage in such a neutral assessment of costs and benefits. In practice, however, debtor's management has an incentive to prefer riskier investments[99]—perhaps in a last-ditch effort to maintain their own jobs—which might lead management to take unwise risks in the hope of achieving a traditional organization.[100]

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[98] Creditors who are significantly over- or undersecured are likely to have different incentives. Creditors who are significantly oversecured have little to risk if the bankruptcy process continues, since they are paid post-petition interest and have a material cushion against loss in value. Creditors who are significantly undersecured have an incentive to seek to maximize the value of the enterprise through a reorganization in which they have a chance of recovering more on their claims.

[99] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305, 334-37 (1976).

[100] *See* Ayotte & Morrison, *supra* note 87, at 539 (finding that "[b]oth senior and junior lenders regularly object to actions taken by the debtor's management" and asking "in whose interest are the managers acting?").

The question we should ask, then, is whether increased secured creditor control has in fact led to inefficient decisions that are systematically skewed in favor of the secured creditor. That is, are debtors in fact passing up otherwise sensible (that is, value-maximizing) investments in the reorganization process, in order to provide secured creditors with a prompt and riskless recovery?

The Report does not provide reliable empirical evidence that, in the real world, debtors are making inefficient decisions that systematically favor secured creditors over other constituencies. To the contrary, recent studies that have investigated precisely this concern suggest that the increased use of secured credit—and the power that secured creditors potentially wield in bankruptcy—has not produced a greater number of inefficient sales or liquidations.

To be sure, secured creditors have more control over the chapter 11 process now than they did in the early days of the Bankruptcy Code. One study by Kenneth Ayotte and Edward Morrison, which examined a set of large bankruptcies filed in 2001, concluded that "creditors with senior, secured claims have come to dominate the Chapter 11 process,"[101] although junior creditors also exerted meaningful "leverage over the reorganization process."[102] The authors found that senior secured lenders had the ability to exert significant control over the process through the terms of DIP financing, including covenants requiring budgets, profitability targets, or deadlines for submitting a plan of reorganization.[103] At the same time, they found "evidence of frequent creditor conflict" between senior and junior constituencies.[104]

Ayotte and Morrison examined the relationship between the ratio of a firm's assets to its secured credit and the outcome of the bankruptcy (sale or reorganization). They found that—consistent with the incentives for various creditor constituencies described above—when secured creditors were undersecured, or the firm had no secured debt, the bankruptcy was more likely to result in a traditional reorganization, and that when secured creditors were oversecured, the bankruptcy was more likely to result in a sale.[105] Thus, the authors concluded that "creditor conflict distorts economic outcomes in bankruptcy," but noted that they could not evaluate or quantify "the efficiency loss associated with this conflict."[106] That is, they could not determine whether creditor conflict resulted in a bias toward inefficient sales or inefficient reorganizations.[107]

Jay Westbrook's more recent study reached different conclusions about the prevalence of secured creditor control. He tested the conventional account of secured creditor control, under which "it has become accepted … that the bulk of Chapter 11 cases are dominated by secured creditors" and that "many, if not most, Chapter 11 cases are effectively terminated by a sale under section 363"—a concern Westbrook himself had expressed in earlier work.[108] To do so, Westbrook analyzed a cross-section of chapter 11 cases of all sizes filed in nine districts in 2006.[109]

Westbrook found that secured creditor control, although important, is "not as pervasive as many have assumed."[110] In about 30% of the cases, secured creditors were owed more than the total scheduled value of the debtors' assets (though a single secured creditor held such a dominant security interest in only about 6% of

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[101] *Id.* at 512. Ayotte and Morrison examined a set of 153 chapter 11 cases filed in the second half of 2001 by public and major private companies. *Id.* at 517.

[102] *Id.* at 512-13.

[103] *Id.* at 514.

[104] *Id.*

[105] *Id.* Ayotte and Morrison noted that significantly oversecured creditors should be less likely to force quick sales, but their data did not show a material difference between cases in which creditors were significantly oversecured and cases in which they were only moderately oversecured. *Id.* at 537-38.

[106] *Id.* at 515.

[107] *Id.*

[108] Westbrook, *supra* note 53, at 832; *see, e.g.*, Elizabeth Warren & Jay L. Westbrook, *Secured Party in Possession*, 22 Am. Bankr. Inst. L.J., Sept. 2003, at 12, 12 (2003)

[109] Westbrook, *supra* note 53, at 833. Westbrook sought to capture a broad spectrum of chapter 11cases, and his figures thus include small business filings as well as "mega" cases. By focusing on 2006, this study captures the last year before the Great Recession and a time when "the secured credit control story was already the well-established conventional wisdom." *Id.* at 837-39.

[110] *Id.* at 834.

cases).[111] In another 10%, secured creditors were owed more than 75% of the value of the debtors' assets.[112] By contrast, in about a third of cases, there was little or no secured debt (secured debt represented less than a quarter of scheduled assets); "those cases … seem more likely to be controlled by the debtor's management … than by a secured creditor."[113] In the middle 25% of cases, debtors had secured debt ranging from 25% to 75% of scheduled asset values; the median amount of secured debt was 56% of asset value.[114] In the median case, then, "a debtor has unencumbered assets to sell or offer as security for DIP financing," and "[i]ts secured creditors may not be in a position to exert control or even decisive influence … over the debtor's management."[115]

Westbrook also examined the prevalence of § 363 sales of debtors and, again, his findings "raise some real questions about the conventional wisdom."[116] Fewer than 30% of cases had § 363 sales of any kind, and many of those sales may not have been sales of substantially all the debtors' assets (the study did not distinguish between sales of a single asset and sales of the debtor as a going concern).[117] As Westbrook commented, "When we saw this figure, we kicked the computer three times and went out for coffee, but when we came back we got the same number."[118] He concluded that the "data strongly suggest that the conventional view that 363 sales dominate Chapter 11 practice is simply wrong."[119]

Finally, Westbrook found that cases with a dominant secured party, as well as cases with a high percentage of secured debt, were *less* likely to have § 363 sales, not *more* likely.[120] He concluded that "[n]ot only [is] secured creditor control … less pervasive than claimed (even in large cases) and 363 sales far less common, but it also appears that the association between them … is undemonstrated and perhaps tenuous."[121]

Perhaps more importantly, recent studies have found no association between secured creditor control and *inefficient* liquidations or § 363 sales—sales that reduce the value available to creditors. For example, a study by Stuart Gilson, Edith Hotchkiss, and Matthew Osborn found that secured creditor control does not lead to inefficient sales or to lower unsecured creditor recoveries.[122] The authors observed that "[a] growing number of academics and practitioners have argued that senior secured creditors have become increasingly powerful in Chapter 11 relative to management. These creditors may have incentive to force the sale of assets to repay their claims even if this means selling at fire sale prices, at the expense of more junior claimants."[123] Based on that narrative, one would hypothesize that "when senior creditors are more powerful, … more assets will be sold—possibly … for less than they would be worth in a stand-alone reorganization."[124]

But the study did not support that hypothesis. The study examined 350 large chapter 11 cases filed between 2002 and 2011. Out of that set, 68% of firms reorganized through a plan, 21% of firms sold substantially all their assets as going concerns, and 11% of firms liquidated.[125] Unlike in the Westbrook study, the authors did find a positive association between higher secured debt ratios and § 363 sales.[126] But they also found that secured

[111] *Id.* at 840-41.

[112] *Id.* at 840.

[113] *Id.* at 839.

[114] *Id.* at 840.

[115] *Id.* at 841.

[116] *Id.* at 842.

[117] *Id.* at 843.

[118] *Id.*

[119] *Id.* Ayotte and Morrison had found a much higher prevalence of sales in their sample, in which about two-thirds of cases resulted in a sale or liquidation. Ayotte & Morrison, *supra* note 87, at 520.

[120] Westbrook, *supra* note 53, at 844.

[121] *Id.* at 845.

[122] Gilson et al. 2015, *supra* note 52.

[123] *Id.* at 4.

[124] *Id.*

[125] *Id.* at 4 tbl. 1.

[126] *Id.* at 5.

creditor control is positively associated *only* with going-concern sales, not with liquidations.[127] They concluded, "[O]ur interpretation is that while secured debt is associated with a higher incidence of *sales of all assets*, it is not linked to a loss of going concern value."[128] Survival rates post-bankruptcy also showed no statistically significant difference between firms sold as a going concern and reorganized firms, suggesting "that asset sales do not lead to less economically efficient outcomes than traditional reorganizations."[129]

In addition, the authors found a *positive* relationship between higher secured debt ratios and overall creditor recovery (the opposite of what one would expect if secured creditor control led to destruction of value), and no relationship between secured debt ratio and unsecured creditor recovery.[130] "Overall, the analysis of recovery rates does not suggest that recoveries either as a whole or to unsecured creditors are lower in cases where senior debtholders potentially have greater control."[131] Moreover, the analysis "does not suggest that fire-sale prices in Section 363 sales lead to lower overall creditor recoveries."[132] That conclusion is consistent with Moody's data showing that creditor recovery rates have increased since the 1980s.[133] In sum, the study's results did not support the conventional narrative, in which secured creditor control results in a loss of value and harms other constituencies.

Similarly, a recent study by Mark Jenkins and David Smith examines the empirical evidence regarding whether "incentive conflicts between senior and junior claimants … lead to inefficient outcomes."[134] They designed the study to test the hypothesis that senior secured creditors often force "inefficient liquidations"—that is, liquidations in which a firm's assets are sold for less than the firm's value as a going concern.[135] They explain that such inefficient liquidations can occur when three factors are present: (1) secured creditors must in fact be able to control the decision whether to liquidate; (2) there must be obstacles that prevent senior and junior creditors from bargaining to reach an efficient outcome; and (3) the senior creditor must have little to gain from continuing the bankruptcy process—something that is true when the senior creditor is close to being fully secured.[136] When a secured creditor is oversecured, junior creditors can, if they have the resources to do so, pay off the secured creditor and take control of the bankruptcy process.[137] Likewise, when a secured creditor is significantly undersecured, its incentives are aligned with the interest of the estate as a whole: It will have an incentive to liquidate if doing so is value-maximizing and to strive for reorganization if that is value-maximizing.[138] Thus, the conditions for inefficient liquidations are most likely to exist when the secured creditor's claim is close to equal to the value of the firm's assets.[139]

Jenkins and Smith examined data from over 800 bankruptcies filed between 1989 and 2011.[140] Of those, 73% ended in reorganization and 27% either in liquidation or a going-concern sale.[141] Based on the observed ratio of the firms' value to their secured debt, Jenkins and Smith estimated that only 8% of firms were liquidated or sold when it would have been more efficient to reorganize them.[142] Moreover, they estimated that the loss amounted to only 0.28% of the reorganization value of all firms in the sample.[143] They note that, because their model does not

[127] *Id.* at 24.

[128] *Id.*

[129] *Id.* at 31.

[130] *Id.* at 29.

[131] *Id.*

[132] *Id*. at 30.

[133] *See* David C. Smith, *An Unnecessary Chapter 11 Overhaul*, Wall St. J., Jan. 8, 2015.

[134] Jenkins & Smith, *supra* note 52, at 1.

[135] *Id.* at 1.

[136] *Id.* at 1, 3.

[137] *Id.* at 3.

[138] *Id.*

[139] *Id.*

[140] *Id.* at 16. Jenkins and Smith used a sample of 834 nonfinancial issuers for which data was available in Moody's Default and Recovery Database.

[141] *Id.* at 26.

[142] *Id.*

[143] *Id*. at 27.

account for the bargaining that in fact often occurs between senior and junior creditors over the potential upside of a reorganization, those estimates "likely overstate the true frequency and cost of inefficient liquidations."[144]

Yet another study investigating the prevalence and effect of § 363 sales concluded that § 363 sales have not "overtaken reorganization."[145] Analyzing over 850 large chapter 11 cases filed between 1982 and 2011, Jared Wilkerson found that 21% of cases over that period involved § 363 sales.[146] Although the percentage of cases involving § 363 sales increased over time and most significantly during the Great Recession (peaking at 41% in 2008), in 2010 and 2011 the percentage of cases involving sales returned to "normalcy," closer to the 21% average.[147] Wilkerson also concluded that secured creditor control "does not appear to lead to more § 363 sales or lower value."[148]

An earlier study by Lynn LoPucki and Joseph Doherty had suggested that § 363 sales generated lower recoveries, as a percentage of prebankruptcy book value, than reorganizations.[149] As Wilkerson explains, however, that study does not show that § 363 sales cause losses of value: "[A]sset sales and reorganizations [may] reflect different populations: one whose value is maximized by sale and another whose value is maximized by reorganizations. Merely because sales generally bring lower value compared to reorganizations doesn't mean that sales don't maximize the value of any particular estate."[150]

One specific aspect of the secured creditor control narrative that has received significant attention is the notion that DIP lenders are able to, and frequently do, force value-reducing § 363 sales through covenants in DIP lending agreements.[151] But, again, the Report includes no empirical data showing that DIP lender control leads to loss of value. To obtain data relevant to that question, the LSTA conducted a study that examined the association between such control provisions in DIP agreements and outcomes in chapter 11 cases (the DIP Study). The DIP Study's sample included all chapter 11 filings by public companies with scheduled assets of at least $500 million between 2006 and October 2012—a total of 157 cases.[152] Debtors in approximately 65% of cases in the DIP Study accessed the DIP market, and the vast majority of those debtors' DIP agreements included control provisions limiting the debtors' flexibility in chapter 11, such as milestones, roll-ups, liens on avoidance actions, and waivers of § 506(c) or § 552(b)—that is, the kind of provisions that the Commission recommends abolishing or restricting.[153]

Despite the pervasive use of such control provisions, only about 25% of the cases in which debtors accessed the DIP market involved an outcome other than a traditional reorganization.[154] That is, only 25% of the cases resulted in a § 363 sale, confirmation of a liquidating plan, or conversion to chapter 7. Among these companies, some filed never intending to reorganize, but used a DIP loan to finance an orderly liquidation or a pre-planned sale.[155] The study did not support the notion that the presence of control provisions affected the likelihood that a particular debtor would reorganize. In fact, other studies have shown that "companies that obtain [DIP] financing while in Chapter 11 are more likely to reorganize successfully, and to reorganize in less time than firms that do not obtain such financing."[156]

For now, what is clear is that no reliable empirical data support the need for the Commission's proposed

[144] *Id.* at 27-28.

[145] Wilkerson, *supra* note 90, at 625.

[146] *Id.* at 600-01 & tbl.1.

[147] *Id.*

[148] *Id.* at 625.

[149] Lynn LoPucki & Joseph Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1, 44 (2007).

[150] Wilkerson, *supra* note 90, at 599; *see also id.* at 605-611 (providing a detailed rebuttal of LoPucki and Doherty's theories regarding the cause of the value differential, including secured creditor control). It has also been suggested that LoPucki and Doherty misinterpreted the data, overstating recoveries in reorganizations. *See* James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691, 692 (2008).

[151] *See, e.g.*, Report at 76-77 & n.301.

[152] See *Supplemental Written Statement of Mark Shapiro*, *supra* note 7.

[153] *Id.*

[154] *Id.*

[155] *Id.*

[156] Gilson 2012, *supra* note 51; *see also* Sandeep Dahiya et al., *Debtor-in-Possession Financing and Bankruptcy Resolution: Empirical Evidence*, 69 J. Fin. Econ. 259, 270-76 (2003).

reforms. While the data we have suggest that secured creditors do exercise more control than formerly over the bankruptcy process, they also suggest that secured creditor control is not producing inefficient outcomes. Before Congress considers the overhaul of a tried-and-true bankruptcy regime on the basis that secured creditor control has harmed the efficacy of the process, it should require clear evidence that such harm has occurred.

3. Chapter 11's Successes

Aside from their inconsistency with empirical data, proposals to "reform" the Bankruptcy Code must overcome a more basic reality: The current Code works very well. The Great Recession put the Code through the most rigorous test it has ever seen, with 20 times more assets flowing through chapter 11 in 2008-2009 than in 2006-2007.[157] Before the financial crisis, the conventional wisdom was that consumers would not buy a car from a company that had been through a bankruptcy.[158] But the experience of the Great Recession was that the flexibility of the Bankruptcy Code played a major role in facilitating the nation's economic rebound.

As Stuart Gilson of Harvard Business School explained:

> The financial crisis demonstrates that Chapter 11, and the debt restructuring industry more broadly, has played a key role in the ongoing recovery of the U.S. economy. The crisis further demonstrates the importance of U.S. bankruptcy laws and restructuring practices in driving the competitiveness of U.S. companies. Beyond helping financially distressed companies preserve value and recover from financial distress, Chapter 11 also encourages risk-taking by giving managers and entrepreneurs a "second bite at the apple" if they take reasonable risks that turn out badly.[159]

Indeed, recent scholarship indicates that the Code's restructuring provisions improve debtors' operating performance. A 2007 study found that debtors increase their operating performance while in chapter 11 and that debtors significantly increase their operating income by the second fiscal quarter in chapter 11.[160] Perhaps unsurprisingly, companies with the highest ratio of debts to assets experience the greatest improvements in operating income while in chapter 11.[161]

Chapter 11 not only fixes and contains financial distress, but does so with remarkable efficiency. Indeed, as Gilson has noted, chapter 11 has only become more efficient since the Great Recession. As the Commission itself acknowledges, the average stay in chapter 11 for public and large private companies has plummeted from almost 1,000 days in 1989 to little more than 100 days in 2013.[162] All else being equal, shorter bankruptcy cases result in greater recoveries for all creditors, since costs are reduced and creditors are paid sooner—which, in light of the time value of money, is the equivalent of being paid more.

It is therefore no surprise that many countries have recently adopted bankruptcy laws modeled on chapter 11, including effective protections for secured creditors, and that those countries have seen real benefits from such reforms. To take three examples, Brazil, the Czech Republic, and China have all recently modified their bankruptcy laws to provide greater protection to secured creditors' nonbankruptcy rights. Emerging data from Brazil and the Czech Republic show the economic benefits of these reforms.

a. Brazil

Brazil's recent bankruptcy reforms indicate that protecting secured creditors' nonbankruptcy rights is key to the efficient operation of credit markets. Historically, Brazil offered little protection for secured creditors,[163]

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[157] Gilson 2012, *supra note* 51, at 23.

[158] *See* David Kiley, *Would You Buy a Car from Chrysler?*, Business Week, May 1, 2009 (noting the concern that "buyers will assume that no one will be around to fix their car").

[159] *Id.* at 35.

[160] Avner Kalay, Rajeev Singhal & Elizabeth Tashjian, *Is Chapter 11 Costly?*, 84 J. Fin. Econ. 774-87, 794 (2007).

[161] *Id.* at 794.

[162] Report at 220-21.

[163] Aloísio Araújo & Bruno Funchal, *Bankruptcy Law in Latin America iPast and Future*, 6 Economía 149,184-86 (2005); Bruno Funchal, *The Effects of the 2005 Bankruptcy Reform in Brazil*, 101 Economics Letters 84, 84, 86 (2008).

subordinating their claims in bankruptcy to administrative, tax, and employee wage claims.[164] Credit was expensive and in short supply.[165] Brazil's 2005 bankruptcy reforms significantly enhanced protections for secured creditors by rearranging the priority rules.[166] As with DIP financing in the United States, Brazil accorded super-priority status to credit extended after a firm entered bankruptcy.[167] And, as in the United States, it subordinated tax claims to the claims of secured creditors.[168] Brazil also capped the priority for workers' claims.[169]

The cost of credit dropped immediately—by 22%, according to one study.[170] The average overnight rate on government-backed loans dropped from 24% in the year prior to the first introduction of the reforms (October 2003) to 18% in the year after their ultimate enactment (June 2005).[171] Commentators observed that the stock markets also reacted positively.[172]

b. The Czech Republic

Czechoslovakia enacted an insolvency law in 1991, largely based on pre-World War II law.[173] According to the Czech National Bank, the law quickly proved inadequate and was amended multiple times.[174] One experimental amendment, in 2000, provided that secured creditors could recover only 70% of the proceeds from the sale of their collateral.[175] Commentators quickly criticized the law as obsolete.[176] In 2007, the nation adopted a new Insolvency Code modeled substantially on our chapter 11.[177] The revised code enhanced the rights of secured creditors by affording them first priority in insolvency, subject only to administrative expenses, while at the same time making insolvency proceedings much shorter and more efficient.[178] These protections drew praise from the European Central Bank.[179] And they produced results: As data from the World Bank shows, the length of proceedings fell by two-thirds while recovery rates tripled.[180]

The average rate of secured creditor recovery in insolvency rose from 18.5% in 2006 to 56% in 2011 and 65.6% in 2014.[181] At the same time, the duration of insolvency proceedings fell from 6.5 years in 2008 to 3.2 years in 2010 to 2.1 years in 2013.[182]

[164] Padma Kadiyala, *Impact of Bankruptcy Law Reform on Capital Markets in Brazil*, 8 Inv. Mgmt. & Fin. Innovations 31, 32 (2011).

[165] Araujo & Funchal, *supra* note 163, at 186.

[166] Lei No. 11.101, de fevereiro de 2005; Kadiyala, *supra* note 164, at 32-33.

[167] *Id.* at 33.

[168] *Id*.

[169] *Id.*; Jacopo Ponticelli, *Court Enforcement, Bank Loans and Firm Investment: Evidence from a Bankruptcy Reform in Brazil* 6 (working paper May 2015), available at http://ssrn.com/abstract=2179022.

[170] Funchal, *supra* note 163, at 86; *see also* Kadiyala, *supra* note 164, at 35 (also discussing decreases in cost of credit).

[171] Kadiyala, *supra* note 164, at 31.

[172] *Id.* at 40.

[173] Czech National Bank, *The Impact of Insolvency Law on Financial Stability* 93, 94, *in Financial Stability Report 2005*, available at http://www.cnb.cz/en/financial_stability/fs_reports/fsr_2005/.

[174] *Id.* at 94.

[175] *Id.* at 100.

[176] *Id.* at 94.

[177] Tomas Richter, *Reorganizing Czech Businesses: A Bankruptcy Law Reform Under a Recession Stress-Test*, 20 Int'l Insolvency Rev. 245, 247 (2011).

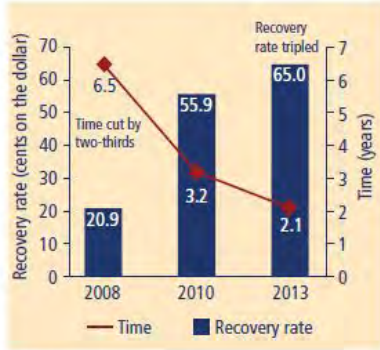
[178] Alois Šatava & Martin Dančišin, *New Czech Insolvency Law on Its Way*, Butterworths J. Int'l Banking & Fin. L., Nov. 2006 , at 450, 450-51; Tomas Richter, *The New Czech Insolvency Act*, Butterworths J. Int'l Banking & Fin. L., June 2006, at 271-72; Coll. Bankruptcy and Settlement Act (Insolvency Act), No. 182/2006 § 298; World Bank, *Doing Business*, available at http://doingbusiness.org /data/exploretopics/resolving-insolvency/good-practices#protecting (showing the duration of insolvency proceedings falling).

[179] *Opinion of the European Central Bank at the Request of the Czech Ministry of Justice*, at 3-4 (18 Oct., 2005), available at https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2005_36_f_sign.pdf.

[180] World Bank, *Doing Business 2014: Understanding Regulations for Small and Medium-Size Enterprises* 116 (2013), available at http://www.doingbusiness.org/~/media/GIAWB/Doing%20Business/ Documents/Annual-Reports/English/DB14-Full-Report.pdf.

[181] Luboš Smrčka et al., *The Possibilities of Reforming Czech Insolvency Law*, in Advances in Finance and Accounting 192, 193 (Drahomira Pavelkova et al. ed. 2012), available at http:// www.wseas.us/e-library/conferences/2012/Zlin/FAA/FAA-31.pdf (breaking down statistics by year); *see also* World Bank, *Doing Business*, *supra* note 178 (estimating that the reforms tripled creditors' rate of recovery).

[182] World Bank, *Doing Business*, *supra* note 178.



Source: Doing Business database.

c. China

The People's Republic of China had no bankruptcy law at all until 1986.[183] Early versions of the law subordinated secured creditors to employees and other claimants.[184] A 1994 directive of the State Council mandated that the first priority in bankruptcy should be to resettle employees, with some assets of the estate—like land rights—earmarked expressly for that purpose.[185]

China's Enterprise Bankruptcy Act, enacted in 2006, adopted significant reforms, including granting first priority to secured creditors and ensuring their access to the full value of their collateral.[186] The new law won accolades from local commentators, academics, and practitioners.[187] Adopting absolute priority was part of a "significant improvemen[t]"[188] over prior law, and was in accord with internationally recommended models for bankruptcy reform.[189]

Indeed, the major international financial institutions regard the protection of secured creditors as essential to healthy credit markets. The United Nations Commission on International Trade Law (UNCITRAL), for example, has urged that bankruptcy "priorities should be based on commercial bargains" instead of "political concerns that have the potential to distort the outcome of insolvency."[190] The World Bank counsels that "[a]ny priority placed ahead of the secured party represents a substantial cost, which is generally transferred back to borrowers in the form of higher interest rates and transaction costs."[191] And the IMF explains that "if the distribution priorities following liquidation recognize the seniority established by contractual terms, creditors will feel confident that they are able to manage, at least to some degree, the risks they incur when making investment decisions."[192]

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[183] Ronald Winston Harmer, *Insolvency Law and Reform in the People's Republic of China*, 64 Fordham L. Rev. 2563, 2565 (1996).

[184] Terence C. Halliday, Foundation for Law, Justice and Society, *Policy Brief: The Making of China's Corporate Bankruptcy Law* 1, 6 (2007), available at http://www.fljs.org/sites/www.fljs.org/files/publications/Halliday.pdf.

[185] Harmer, *supra* note 183, at 2572.

[186] Enterprise Bankruptcy Law (promulgated by the Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective June 1, 2007), §§ 109, 113, *translated in* 17 Int. Insolv. Rev. 33 (2008) (P.R.C.); Halliday, *supra* note 184 (describing changes).

[187] *See, e.g.*, Victoria Ruan, *Why stigma holds back China's bankruptcy law*, South China Morning Post, Aug. 12, 2013 ("China now has one of the world's best written bankruptcy laws on its books."); Ravi Bendapudi, *People's Republic of China Bankruptcy Law*, 6 Santa Clara J. Int'l L. 205, 219 (2008); Michael E. Burke et al, *China*, 41 Int'l Law 777, 784-87 (2007); Maria Antonietta Tanico, *China's New Bankruptcy Law*, ABI International Committee Newsletter, Apr. 2007, available at http://www.abiworld.org/committees/newsletters/international/vol-14num2/Internationalnewletter.html.

[188] Steven J. Arsenault, *The Westernization of Chinese Bankruptcy*, 27 Penn. St. Int'l L. Rev. 45, 57 (2008).

[189] *Id.* at 57, 77, 79-80 (describing how the changes meant China's laws on creditor protection now follow UNCITRAL recommendations); *see also* Roman Tomasic & Zinian Zhang, *China's Enterprise Bankruptcy Law: Implementation of the Corporate Reorganization Provisions, in Law and Policy for China's Market Socialism* 55, 62-64 (John Garrick ed., 2012).

[190] UNCITRAL, *Legislative Guide on Insolvency Law: Part One* 13 (2004), available at http://www.uncitral.org/pdf/english/texts/insolven/05-90722_Ebook.pdf.

[191] World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* 21 (2001), available at http://www.worldbank.org/ifa/ipg_eng.pdf.

[192] Legal Department, IMF, *Orderly and Effective Insolvency Procedures: Key Issues* (1990), available at http://www.imf.org/external/publs/ft/orderly/.

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The bottom line is that, while financial markets and chapter 11 practice have indeed changed significantly since 1978, there is no reliable evidence that those changes have been harmful. More specifically, there is no reliable evidence that increasing secured creditor control has led to otherwise viable companies being liquidated or sold for fire-sale prices, or that it has unfairly decreased more junior constituencies' recoveries. Indeed, the chapter 11 process has become faster, more efficient, and in many ways better than it was in the past. And other nations have sought to model their own insolvency laws on chapter 11 precisely because it does work so well. Put simply, the available evidence does not suggest that the chapter 11 process is ineffective or that major reforms are necessary.

B. The Report's Proposals Would Have Harmful Real-World Effects

The Report also fails to take adequate account of the costs of implementing its proposals. Overall, the Commission's proposed reforms would make bankruptcy cases longer, more complicated, and more expensive. They would also inevitably increase the cost of credit.

1. Effect On The Bankruptcy Process

Many of the Report's proposals would make bankruptcy proceedings longer, more complex, and thus costlier—in turn reducing recoveries to all constituencies and extending the bankruptcy "overhang" that inhibits businesses' rehabilitation.

Indeed, the Report makes clear that many of its proposals are *intended* to make bankruptcy cases longer. For instance, the Report's proposal for a 60-day moratorium on § 363 sales is designed precisely to extend the length of bankruptcy, in the hope that more companies will be reorganized and that secured creditors will be less able to force value-reducing sales. As discussed above, however, there is no reliable evidence that such value-reducing sales are actually occurring. The benefits of the proposal are thus highly uncertain, while the costs are obvious. All else being equal, more time in bankruptcy means higher administrative costs and lower recoveries for stakeholders. More time in bankruptcy also potentially makes it more difficult for emerging companies—whether reorganized or sold as going concerns—to regain their financial footing and revitalize their businesses.

Many of the Commission's other proposals, even if not expressly designed to lengthen bankruptcy proceedings, would have that effect. For example, the Commission's proposal to give secured creditors adequate protection of only the foreclosure value of their collateral would materially change the dynamics of chapter 11 proceedings in a way that would be likely to make them longer and less efficient. Without the ability to demand adequate protection of the full going-concern value of their collateral, secured creditors would have significantly less ability to influence the direction of the proceedings. And, as described in further detail below, existing management and out-of-the-money junior creditors would have the incentive and ability to prolong cases in the hope of a traditional reorganization or increased recovery. Again, whether this is a good thing or a bad thing depends on whether secured creditor control adversely affects stakeholders as a whole—but, as discussed above, the Report has not provided persuasive evidence that it does.

The Commission's proposals would also make bankruptcy substantially more complex. As most bankruptcy judges and practitioners would no doubt agree, "no problem in bankruptcy is more perplexing than the problem of valuation."[193] Yet the Report's proposal to limit adequate protection would require bankruptcy courts not only to ascertain the going-concern value of the enterprise—a difficult enough task in itself—but also to establish the value a secured creditor would obtain in a state-law foreclosure sale. This additional valuation inquiry is even more difficult and uncertain because it involves determining what would happen in hypothetical sales that rarely occur in practice. Moreover, when they do occur, creditors have the right to credit bid, but the Report demands that bankruptcy courts determine what state-law foreclosure sales would yield if creditors lacked this right.[194] Likewise, the "redemption option value" proposal would require bankruptcy courts to determine the value of a hypothetical option to purchase the firm, which entails ascertaining the expected volatility in the firm's value over the redemption period—a notoriously difficult inquiry.[195] These multiple new judicial valuations run contrary to the Bankruptcy

[193] *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 466 n.5 (1999) (Stevens, J., dissenting).

[194] Report at 67.

[195] *See id.* at 221 & n.795 (proposing use of Black-Scholes option valuation model to value redemption option).

Code's preference for more efficient and typically more accurate market valuations.[196] Each additional judicial valuation would cost substantial money and time and lead to expensive battles of the experts that would further lengthen the case and deplete the estate. That is in no one's interest.

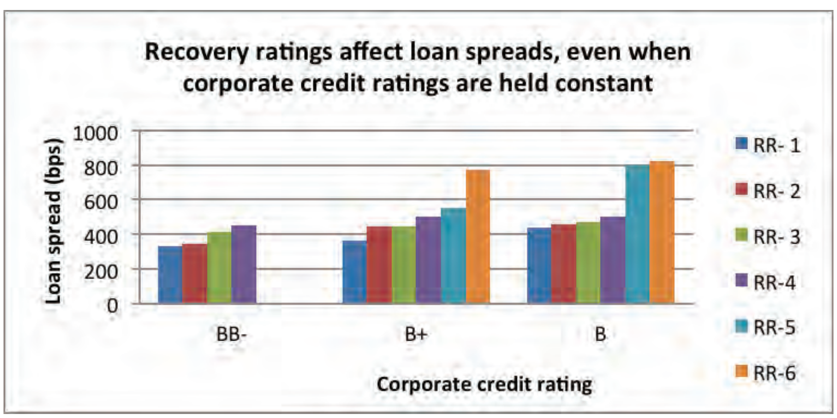
2. Effect On Credit Markets

As described in further detail below, the inevitable consequence of several of the Report's proposals, including the proposals related to adequate protection (discussed in Part III.A) and redemption option value (discussed in Part III.F), would be to reduce the recoveries on account of secured claims. That, in turn, would almost certainly increase the cost of capital for the non-investment-grade companies that rely heavily on secured credit to invest in the development of their businesses. Indeed, the ratings agency Fitch has already warned that the Report's recommendations "could adversely alter recovery prospects of first lien debt claim holders."[197] To the extent that the Report's proposed reforms reduce secured creditors' recoveries in the event of default, lenders will take that into account in pricing and extending credit.

To understand why the Report's proposed reforms would increase the cost of capital, and why that is a problem, it is necessary to understand the basic operation of the market for commercial loans to non-investment-grade companies ("leveraged loans"). Today's leveraged loans are usually syndicated among a group that is likely to be made up predominantly of nonbank lenders, such as institutional investors or collateralized loan obligations (CLOs).[198] Leveraged loans are frequently secured by a blanket lien on substantially all of the borrower's assets.

Investors in leveraged loans weigh a variety of factors in deciding whether to lend. As with all loans, one key consideration is the borrower's ability to service its debt through its revenue. Because borrowers in the leveraged loan market are by definition riskier than investment-grade borrowers, however, another important consideration is the anticipated recovery on the loan in the event of the borrower's default. In addition, many of the most significant participants in the leveraged loan market are restricted by regulation or charter to investing in loan instruments with particular ratings. The ratings agencies in turn base those ratings in part on their own assessment of likely recovery in the event of default. Lower recovery given default would thus increase the riskiness, and hence the price, of credit for non-investment-grade companies, and might cause some institutional investors to curtail their lending.

Indeed, ratings and interest rate data for companies in the senior secured loan market demonstrate that lenders charge more interest to borrowers expected to have a lower "recovery given default" (RGD), even holding the borrowers' credit rating constant. We collected a sample of 132 issuers rated BB- by Standard & Poor's, 207 issuers rated B+, and 516 issuers rated B. We then identified the recovery ratings assigned by Standard & Poor's for these companies' debt issues. In the chart below, RR-1 represents 90-100% expected RGD; RR-2 represents 70-90% expected RGD; RR-3 represents 50-70% expected RGD; RR-4 represents 30-50% expected RGD; RR-5 represents 10-30% expected RGD; and RR-6 represents 0-10% expected RGD. As the chart illustrates, for companies with the same credit rating, the average interest rate increases as the recovery rating decreases.



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[196] *See 203 N. LaSalle*, 526 U.S. at 457-58 (noting that "one of the Code's innovations [was] to narrow the occasions for courts to make valuation judgments" in favor of "decisions tested by competitive choice").

[197] FitchRatings, *supra* note 55.

[198] *The Handbook of Loan Syndications and Trading* 22 (Allison Taylor & Alicia Sansone eds. 2007).

Across all three categories, the weighted average interest rate increase between a recovery rating of 1 and a recovery rating of 2 is 32 basis points (0.32%). That increase is significant, viewed in the context of the loan market as a whole. As of the end of 2014, $830 billion of institutional loans—loans sold to nonbank lenders—were outstanding.[199] If the expected recovery given default of those loans decreased from RR-1 (95%) to RR-2 (80%), the additional interest could be more than $2.5 billion per year.

Consistent with this evidence, market participants testified before the Commission that reducing secured creditor recoveries would almost certainly increase the cost of leveraged loans.[200] Secured credit costs less than unsecured credit precisely because expected recovery in the event of default is higher.[201] Lowering expected recovery, or making it more uncertain, would result in difficulties pricing loans, reduced loan sizes, more expensive credit, a reduction in lenders willing to provide credit (as risk-averse lenders will drop out of the market), and a decrease in the flow of capital to non-investment-grade companies.[202] As one witness put it:

> [A]ffordable, secured financing will be available to borrowers only if secured creditors' rights will be enforced in the event of default, including in the case of the borrower's bankruptcy or insolvency. To be sure, from a short-term perspective, one might facilitate a reorganization by … weakening secured creditors' right to obtain the value of their collateral. But that kind of legal regime would deprive potential lenders of the security of repayment that brings many risk-averse lenders into the credit markets. At the end of the day, weakening the rights of secured creditors in bankruptcy would inevitably limit the credit available to borrowers, restricting their opportunities to preserve and expand their businesses.[203]

The problem is not limited to companies outside bankruptcy. The Commission's proposals to restrict the permissible terms of DIP lending agreements would have similar effects on debtors seeking DIP financing in bankruptcy. Each of the DIP lending provisions that the Commission proposes to limit or abolish lowers a debtor's risk, resulting in less expensive credit.[204] Each, therefore, has a price; as one witness with extensive experience with the DIP market put it, "Complete prohibitions on such provisions will necessarily be factored into terms and pricing and may have the unintended consequences of increasing DIP pricing and fees or, in some cases, cause the lender to not make any DIP financing available (or at least, a smaller quantum available)."[205]

The effect of legal change on the market is sometimes brushed aside with the comment, "The market will adjust."[206] That is certainly true; the leveraged loan market and DIP market will not disappear if the Report's recommendations to amend the Code are adopted. It does not follow, however, that the market adjustment will be benign. An increase in the cost of credit, or a reduction in the number of institutions who are willing to provide credit, would have damaging consequences for distressed and non-investment-grade companies who must look to the leveraged loan market (or debtors-in-possession who need to access the DIP market) for necessary capital.

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[199] Ted Basta, *The Secondary Loan Market 2014: A Year-In-Review*, LSTA Loan Market Chron. 63, 63 (2015).

[200] Lee Shaiman, *Testimony Before the ABI Chapter 11 Reform Commission* (Oct. 17, 2012), available at http://commission.abi.org/sites/default/files/statements/17oct2012/Final_Shaiman_Written_ Testimony.pdf; Michael Haddad, *Testimony Before the ABI Chapter 11 Reform Commission* (Nov. 13, 2012), available at http://commission.abi.org/sites/default/files/statements/15nov2012/Michael_Haddad. doc; A.J. Murphy, *Testimony Before the ABI Chapter 11 Reform Commission* (Oct. 17, 2012), available at http://commission.abi.org/sites/default/files/statements/17oct2012/Murphy_testimony_final.DOC.

[201] Indeed, the ratings agencies explicitly consider "the expected relative recovery characteristics of an obligation upon the curing of a default, emergence from insolvency or following the liquidation or termination of the obligor or its associated collateral" when rating investments, which in turn drives the interest rate. FitchRatings, *Recovery Ratin*gs, available at https://www.fitchratings.com/web_content/ ratings/recovery_factsheet.pdf.

[202] Shaiman, *supra* note 200.

[203] Murphy, *supra* note 200.

[204] Schulte Roth & Zabel, *ABI Commission Report Recommendations on DIP Financing Would Eliminate Lender Protection* (Dec. 30, 2014), available at http://www.srz.com/files/News/c02da020-b803-4704-a727-25c0e16d29ea/Presentation/NewsAttachment/dc355235-fd79-45b9-87a6-32f0aed2944c /123014_ABI_Commission_Report_Recommendations_on_DIP_Financing_Would_Eliminate_Lender_ Protection. pdf; *Supplemental Written Statement of Mark Shapiro, supra* note 7. *See infra* Part III.E for a discussion of the Commission's proposals on DIP financing.

[205] *Supplemental Written Statement of Mark Shapiro*, *supra* note 7.

[206] *See, e.g., Transcript of the October 26, 2012 Field Hearing Before the ABI Commission To Study the Reform of Chapter 11, available at* http://commission.abi.org/field-hearing-ncbj-october-26-2012, (statement of Michael Richman).

Empirical studies confirm the common-sense conclusion that credit is more freely available when secured creditors' nonbankruptcy rights are protected in bankruptcy. A comparative study by researchers from the World Bank and Harvard, for example, found that stronger protections for creditors, including respect for secured creditors' priority, were correlated with a higher ratio of private credit to GDP.[207] The authors also found that the ratio rises when creditor rights are strengthened through reforms to bankruptcy laws.[208] Another comparative study similarly found that strong creditor protections are associated with enhanced loan availability on favorable terms, such as more concentrated ownership, longer maturity periods, and lower interest rates.[209]

Research focused on the United States has also shown that laws restricting secured creditors' rights increase the cost of credit. For example, one study found that small (unincorporated) firms in states with unlimited homestead exemptions were 30 to 32% more likely to be denied credit, received smaller loans, and were subject to higher interest rates.[210]

Other analogous empirical research suggests that certain bankruptcy reforms intended to benefit debtors may give rise to the unintended consequence of reducing the availability of credit to non-investment-grade borrowers who rely on secured credit. For example, one study concluded that higher state bankruptcy exemptions intended to benefit low-income and low-asset debtors actually increase the amount of credit available to high-income borrowers and reduce the credit available to low-income borrowers.[211] Another study reached a similar conclusion in the context of the market for mortgage and home improvement loans.[212]

The experience of countries that have adopted bankruptcy reforms similar to those proposed by the Commission underlines the point. The U.K. provides a good example. English common law divides security interests into "fixed" and "floating" charges. The floating charge is a lien that "floats" across all of a company's assets, including items (like inventory) that are continually in flux.[213] The fixed charge, by contrast, relates to specific pieces of property.[214] Fixed charge holders are always paid first in insolvency; floating charge holders are paid after a class of unsecured creditors known as preferential debt holders, but before general unsecured creditors.[215]

The U.K. recently attempted to use the distinction between fixed and floating charges to boost the recovery of unsecured creditors in insolvency.[216] The Enterprise Act of 2002 created a carve-out, known as the "prescribed part," that diminishes the value of floating charges to pay a portion of the claims of general unsecured creditors.[217] The prescribed part encompasses twenty percent of the value of the encumbered property, up to a cap of £600,000.[218] The administrator of the insolvency must set those funds aside, and the secured lender may access them only after unsecured creditors have been paid in full.[219]

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[207] Simeon Djankov et al., *Private Credit in 129 Countries*, 84 J. Fin. Econ. 299, 301, 312-23 (2007); *see also* Jun Qian & Philip E. Strahan, *How Laws and Institutions Shape Financial Contracts: The Case of Bank Loans*, 62 J. Fin. 2803 (2007); Vikrant Vig, *Creditor Rights and Corporate Debt Structure*, available at http://www.hbs.edu/units/finance/pdf/Collateral_Vig_HEcon.pdf.; Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113 (1998).

[208] Djankov, *supra* note 207, at 301.

[209] *See* Qian & Strahan, *supra* note 207, at 2804.

[210] Jeremy Berkowitz & Michelle J. White, *Bankruptcy and Small Firms' Access to Credit*, 35 RAND J. Econ. 69, 78 (2004); *see also* Allen N. Berger, Geraldo Cerqueiro, & María Fabiana Penas, *Does Debtor Protection Really Protect Debtors? Evidence from the Small Business Credit Market*, 35 J. Banking & Fin. 1843, 1844 (2011) (examining the impact of personal exemption laws on unlimited liability small firms and finding that higher exemptions lead to less credit access for borrowers and harsher loan terms, including higher interest rates).

[211] Reint Gropp, John Karl Scholtz, & Michelle White, *Personal Bankruptcy and Credit Supply and Demand*, 112 Quarterly J. Econ. 217, 219-20 (1997).

[212] Emily Y. Lin & Michelle J. White, *Bankruptcy and the Market for Mortgage and Home Improvement Loans*, 50 J. Urban Econ. 138, 140 (2001).

[213] *Re Spectrum Plus Ltd*, [2005] UKHL 41, [2005] 2 AC 680, at [99]-[111].

[214] *Id* at [99], *citing Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch 284, 295 (English law).

[215] Insolvency Act 1986, s. 40; Companies Act, 2006, c. 46 § 754.

[216] *See generally* Adrian J. Walters, *Statutory Erosion of Secured Creditors' Rights: Some Insights from the United Kingdom*, 2015 U. Ill. L. Rev. 543.

[217] Insolvency Act, 1986, c. 45 § 176A (U.K.).

[218] Insolvency Act, 1986 (Prescribed Part) Order, 2003. S.I. 2003/2097.

[219] Insolvency Act, 1986 § 176A(2). The U.K. sought to compensate secured creditors for the creation of the prescribed part by abolishing

Recent evidence suggests that the prescribed part may have failed in its aim. As one scholar put it, secured lenders "will invariably and inevitably adjust to legal changes that affect … their interests."[220] Because asset-based lenders now know that up to £600,000 of collateral may be taken from them in insolvency to pay general unsecured creditors, they must diminish the borrowing base for, and thus reduce the credit they extend to, any business they deal with.[221] When the government proposed increasing the prescribed part in 2011, lenders pointed out that any increase would reduce the availability of credit for businesses,[222] and the increase was rejected.[223]

Sweden offers another example of the potential harm to credit markets that can be caused by the kind of reform the Commission proposes. Like the U.K., Sweden maintains a distinction between fixed and floating security interests, affording a higher priority to fixed liens. In 2004, Sweden reduced the rights of secured creditors by enabling the floating charge to secure only 55% of the value of collateral, making the remaining value available to other creditors.[224] But the effort backfired: It raised interest rates and reduced the availability of credit.[225] Sweden responded by abolishing the 55% rule, once again allowing floating charges to attach to the full value of collateral.[226] Sweden thus provides a cautionary tale about the potential unintended consequences of reform.

In sum, because secured lending supplies non-investment-grade companies with a means of obtaining financing that their risk profile might not otherwise allow them to obtain, the Report's proposals could have a perverse outcome. By attempting to increase such companies' flexibility in bankruptcy, the Report's proposals may decrease the flexibility and resilience of the vast majority that are not in bankruptcy—as well as those in bankruptcy that need to access the DIP market—hurting the very companies the Report's proposed reforms are designed to help.

C. The Report Rejects Basic Principles Of Bankruptcy Law

The Report's approach to bankruptcy reform is flawed for a still more basic reason: The Report rejects long-standing and fundamental principles of bankruptcy law, reflected in the careful architecture of chapter 11 as it exists today, and replaces them with a "balancing" of parties' interests guided by the Commission's view of "subjective fairness."

Since before the enactment of the Code, bankruptcy law has been designed to address the problem created when a debtor has too few assets to satisfy the legitimate demands of its creditors. Creditors of an insolvent debtor may compete to grab assets, potentially destroying the debtor's going-concern value in the process and reducing the recovery of creditors as a whole. Moreover, that dynamic could lead to an inequitable distribution, as faster-moving creditors get paid in full, while slower-moving creditors of equal priority recover nothing. Bankruptcy law in general works to maximize the value of the debtor's assets—staying individual creditor actions in favor of a collective process—and to ensure that those assets are distributed fairly and equitably among competing stakeholders according to their nonbankruptcy rights and priorities.[227] As a rule, it modifies nonbankruptcy rights only where necessary to serve some *bankruptcy* purpose—that is, only where necessary to ensure that the bankruptcy goals of maximizing value and equitable distribution are served.[228]

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the preferential status of debts owed to the government, thus shrinking the list of preferential debt holders who were paid ahead of floating charge holders. Edward Bailey, *Corporate Insolvency: Law and Practice* ¶ 28.5 (2007).

[220] Walters, *supra* note 216, at 546.

[221] Andrew Rotenberg & Adam Scarrott, *Asset Based Lending: Demystifying a Trend*, PLC Mag., Oct. 2010, at 1, 6, available at http://www.practicallaw.com/3-503-2688.

[222] Response of the Asset Based Finance Assoc. to Insolvency Service Consultation (Apr. 27, 2011) (on file with LSTA).

[223] Insolvency Service, *Consultation on Reforms to the Regulation of Insolvency Practitioners* 6, 12 (2011).

[224] Geraldo Cerqueiro, Steven Ongena & Kasper Roszbach et al., Sveriges Riksbank, *Collateralization, Bank Loan Rates and Monitoring*, J.Fin (forthcoming) manuscript at 8, available at http://ssrn.com/abstract=1908097.

[225] *Id.* at 19-21, 28.

[226] Wolfgang Faber & Brigitta Lurger, *National Report of the Transfer of Movables in Europe, Vol. 5: Sweden, Norway and Denmark, Finland, Spain* 162 (2011). In 2009, Sweden further protected secured creditors by ranking their claims above those of the debtor's employees. *Id.*

[227] *See, e.g.*, Douglas G. Baird, *Elements of Bankruptcy* 4-5 (6th ed. 2014); Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law* 7-19 (1986).

[228] *Butner v. United States*, 440 U.S. 48, 54-55 (1979). Although this principle is sometimes referred to as the *Butner* principle, *Butner* was merely describing the approach that Congress has adopted in the bankruptcy law.

Chapter 11 is no different. Its particular genius is to provide a vehicle through which a failing business can be resuscitated and the business's going-concern value can be preserved and distributed among the various stakeholders. But chapter 11 does not itself take a view as to *how* that value should be distributed. Rather, with minor exceptions, it simply implements the rights and priorities established through nonbankruptcy law. Indeed, chapter 11 contains a careful and highly reticulated set of interlocking provisions designed to ensure that secured creditors retain their nonbankruptcy priority over other creditors in the value realized from their collateral.

The Report's proposals would seriously undermine the fundamental principle, which undergirds chapter 11 as currently constructed, that parties' nonbankruptcy rights and priorities are respected. For instance, the Report advocates doing away with the absolute priority rule—the rule, which reflects nonbankruptcy rights, that creditors are paid before equity-holders—in the great majority of chapter 11 cases. Likewise, it would compromise the absolute priority rule in large chapter 11 cases by paying junior creditors before senior creditors are paid in full—and, indirectly, by denying secured creditors adequate protection of the full value of their collateral.

These dramatic changes are problematic from a bankruptcy policy standpoint for several reasons. As an initial matter, bankruptcy law respects the parties' nonbankruptcy bargains *because* doing so is fair. Altering those bargains where it is not necessary to do so to serve a bankruptcy purpose violates bankruptcy's basic vision of fairness and equity. Moreover, changing parties' substantive rights in bankruptcy necessarily creates perverse incentives to forum-shop in and out of bankruptcy. Finally, abandoning the core principles that have formed the backbone of chapter 11 makes commercial law uncertain when it should be clear and predictable.

1. Bankruptcy Law's Basic Principles

Chapter 11 as it exists today embodies two fundamental principles: (1) it is designed to maximize value for all stakeholders; and (2) by and large, it does not impose a distributional scheme of its own, but respects the distributional priorities for which the creditors and shareholders bargained outside of bankruptcy. These are not merely normative principles; they describe the way chapter 11 was in fact designed and functions today.[229] Because the Commission's proposals would break from both principles, it is worth discussing each of them in more detail.

a. Value Maximization

The goal of bankruptcy is "to permit the owners of assets to use those assets in a way that is most productive to them *as a group* in the face of incentives by individual owners to maximize their own positions."[230] That is, its aim is to maximize the value of the bankruptcy estate for the benefit of all constituencies. The central insight of chapter 11 is that in many situations the best way to maximize the value of the estate is to keep the business together as a going concern, rather than to liquidate its assets piecemeal. By preserving firms whose highest and best use is as a going concern, chapter 11 ensures that stakeholders can realize the "going-concern surplus" that would be lost if such a firm were liquidated.

That is not to say, however, that all firms can or should be reorganized. Bankruptcy is a tool that that can help a distressed business facing a problem caused by a short-term liquidity crisis or excessive debt levels—not a tool that can save every company in economic trouble. A widget company that loses $1 on every widget it sells, for example, cannot through any bankruptcy process be converted into a successful and profitable enterprise. Some companies are worth more liquidated than as going concerns. A firm that lacks a viable business model, and whose assets would have greater value if sold to the highest bidder than they would in the hands of current management, is not a candidate for reorganization.[231] The Bankruptcy Code reflects this principle by providing that a debtor's business can be reorganized *only* if doing so maximizes value for creditors: A chapter 11 plan of reorganization cannot be confirmed unless all nonconsenting creditors are at least as well off as they would be in a chapter 7 liquidation.[232]

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[229] We believe these principles also describe chapter 11 as it should be. There is, however, a divide among bankruptcy scholars and policymakers on the normative question whether bankruptcy should be distributionally neutral; some believe that it is proper for bankruptcy to serve its own distributional ends. *See, e.g.,* Elizabeth Warren, *Bankruptcy Policy*, 54 U. Chi. L. Rev. 775, 776-77 (1987). As discussed further below, we believe that it should not, in part because of the distortions and perverse incentives created by having different distributional schemes in and out of bankruptcy.

[230] Jackson, *supra* note 227, at 5.

[231] *See* Baird, *supra* note 227, at 58-59; Jackson, *supra* note 227, at 209-13.

[232] 11 U.S.C. § 1129(a)(7)(A).

To be sure, reorganization of businesses in chapter 11 may benefit persons and entities other than the creditors and shareholders who own the firm. For instance, it may benefit the firm's employees if they can keep their jobs in the reorganized entity. It does not follow, however, that a company whose creditors would be better off if it were liquidated should be kept alive through chapter 11. Chapter 11 saves jobs because it stops viable companies from being torn apart by the actions of individual creditors acting without regard to the stakeholders' collective interests—not because it props up businesses whose assets can be put to their highest and best use in someone else's hands. Indeed, by facilitating the transfer of assets from non-viable companies to more productive uses, chapter 11 spurs the creation of more jobs in the economy as a whole.

b. Respect for Nonbankruptcy Distributional Rules

The second fundamental principle of chapter 11 is that—by and large—it distributes value according to the rights and priorities established under nonbankruptcy law. With narrow exceptions, a creditor's claim is allowed in bankruptcy to the same extent it is enforceable outside bankruptcy under nonbankruptcy law.[233] Moreover, again subject to a few minor exceptions, chapter 11 provides a forum in which creditors and shareholders can vindicate their claims and recover according to the priorities established under state law; it does not itself change those priorities.[234] As the Supreme Court has explained:

> Congress has generally left the determination of property rights in the assets of a bankrupt's estate to state law. … Unless some federal interest requires a different result, there is no reason why [property] interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding. Uniform treatment of property interests by both state and federal courts within a State serves to reduce uncertainty, to discourage forum-shopping, and to prevent a party from receiving a windfall merely by reason of the happenstance of bankruptcy.[235]

One critical way in which chapter 11 preserves creditors' nonbankruptcy rights and priorities is through the absolute priority rule. Stated simply, the absolute priority rule requires that senior creditors be paid in full before any value is distributed to junior creditors, and that junior creditors be paid in full before any value is distributed to shareholders.[236] Because, under nonbankruptcy law, creditors with valid security interests have first claim to the proceeds of their collateral, absolute priority requires that secured creditors be paid the full value of their collateral before unsecured creditors are paid. Unsecured creditors may then recover out of any remaining unencumbered assets. Unless all nonconsenting creditors are paid in full, no value may be distributed to shareholders. Absolute priority has long been the basic rule of distribution under U.S. bankruptcy law precisely because it mirrors nonbankruptcy entitlements.[237]

Chapter 11 thus respects secured creditors' basic state-law entitlements. Outside bankruptcy, a secured creditor holds a property interest in its collateral: In the event of default, the creditor is entitled to foreclose and take the collateral, up to the amount of the creditor's claim. Put another way, a secured creditor has priority over junior creditors in any value that is derived from its collateral.[238] The Bankruptcy Code seeks to enforce, to the greatest extent possible, this basic nonbankruptcy bargain, under which, as Judge Learned Hand famously put it, a secured creditor has the right "to get [its] money or at least the property" securing the debt before junior creditors are paid out of the proceeds of that property.[239] A series of interlocking Bankruptcy Code provisions are carefully designed

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[233] *See Id.* § 502(b)(1); *Travelers Cas. & Sur. Co. of Am. v. Pacific Gas & Elec. Co.*, 549 U.S. 443, 450-51 (2007).

[234] Many of the exceptions are designed to serve bankruptcy's central goal of maximizing the value of the enterprise. For instance, the priority for administrative expenses under § 507(a)(2) is designed to ensure that the debtor can continue to operate in bankruptcy and attempt to reorganize, rather than being liquidated at the outset because it cannot afford the cost of staying in business. Similarly, the priority for unpaid wage claims under § 507(a)(4) helps to ensure that employees do not abandon the firm. To be sure, some other exceptions to nonbankruptcy priority likely cannot be justified on that ground—such as the priority for tax claims in § 507(a)(8). As a general rule, however, the Bankruptcy Code respects nonbankruptcy priorities unless there is a clear bankruptcy reason for departing from those priorities.

[235] *Butner*, 440 U.S. 48, 54-55.

[236] *See* 11 USC § 1129(b)(2); *id.* §§ 725-726; *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 114-17 (1939).

[237] *See, e.g.*, Baird, *supra* note 227, at 57-75.

[238] *See, e.g.*, U.C.C § § 9-607 (describing right of secured creditor to collect on and enforce security); 9-608 (describing application of proceeds of secured creditor's collateral and secured creditor's right to a deficiency claim); 9-610 (describing procedures for sale of collateral after default); 9-615 (describing procedures for application of proceeds of sale of collateral).

[239] *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935) (noting that a secured creditor is entitled "to get his money or at least the

to ensure that secured creditors receive the benefit of that basic bargain.

To start, § 506(a) of the Bankruptcy Code "bifurcates" an undersecured creditor's claim into a secured claim equal to the value of its collateral and an unsecured claim for the remainder. The value of the creditor's collateral and thus its secured claim is determined "in light of the purpose of the valuation and of the proposed disposition or use of such property."[240] The Supreme Court has explained that, where a creditor's collateral will be retained by the debtor and used under a plan of reorganization, the collateral should be valued for purposes of § 506(a) not at its "foreclosure value," but instead at its value to the reorganized debtor.[241] In chapter 11, a secured creditor is entitled to opt out of the § 506(a) bifurcation and choose to have its entire claim treated as fully secured unless its collateral is being sold or its security interest is of inconsequential value.[242]

In turn, § 1129(b) of the Code specifies the minimum treatment that must be accorded a secured claim under a chapter 11 plan. Section 1129(b) provides that, to be confirmed over the objection of a dissenting class of secured creditors, a plan must be "fair and equitable" to that class.[243] A plan may fulfill that requirement in one of three ways. *First*, the plan may provide that the creditor will be paid the full amount of its secured claim over time in a stream of payments with a present value equal to the value of the creditor's collateral, and that the creditor will retain its lien until the secured claim is paid in full.[244] Where a creditor has elected to have its claim treated as fully secured, the result is that the creditor will retain its lien until its entire claim is paid in full. *Second*, the plan may provide for a sale of the secured creditor's collateral to a third-party buyer, subject to the secured creditor's right to credit-bid its claim at the sale and thus take the collateral if it proves to be worth more to the secured creditor than to other potential buyers.[245] *Third*, the plan may grant the secured creditor the "indubitable equivalent" of its secured claim.[246] The upshot of these provisions is that—unless the creditor is otherwise provided the "indubitable equivalent" of its claim—the secured creditor always retains the right either to take its collateral or to keep its lien until it is paid in full. That is precisely the bargain the secured creditor made outside bankruptcy—"to get [its] money, or at least the property."

A secured creditor whose collateral is sold during the chapter 11 proceeding receives equivalent protections. While a debtor is permitted, with court approval, to sell a secured creditor's collateral during the bankruptcy case, the creditor is protected by being given the right to credit-bid its claim at the sale.[247] As in the case of a sale under a chapter 11 plan, the secured creditor has a choice between taking the value realized for the collateral at auction, or taking the collateral itself if it values the collateral more highly than other bidders do. The Code thus ensures that a secured creditor's collateral will not be sold for less than what the creditor believes to be fair value.[248]

Finally, the Code ensures that the secured creditor's basic entitlement to the full value of its collateral will not be lost or diluted due to a debtor's actions during the bankruptcy case. While a debtor seeking to reorganize its business may retain the secured creditor's collateral during the bankruptcy case, the Bankruptcy Code grants the secured creditor the right to "adequate protection" to ensure that it is not harmed by the debtor's doing so. Thus, where necessary for the reorganization, the secured creditor's right to foreclose may be stayed, and the debtor may be permitted to use cash collateral or to obtain a new loan in bankruptcy, with priority over the secured creditor's security interest, in order to keep the business operating and intact during the reorganization proceedings.[249] But the debtor may do so only if the secured creditor receives "adequate protection" against any resulting diminution in the value of its collateral.[250]

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property" and that bankruptcy law does not deprive the creditor of that right without a substitute of "indubitable equivalence").

[240] 11 U.S.C. § 506(a).

[241] *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 963-65 (1997) (chapter 13).

[242] 11 U.S.C. § 1111(b).

[243] *Id.* § 1129(b)(1).

[244] *Id.* § 1129(b)(2)(A)(i).

[245] *Id.* § 1129(b)(2)(A)(ii); *RadLAX Gateway Hotel, LLC v. Amalgamated Bank*, 132 S. Ct. 2065, 2070 (2012).

[246] 11 U.S.C. § 1129(b)(2)(A)(iii).

[247] *Id.* § 363(k).

[248] *Id.* § § 363(k), 1129(b)(2)(A)(ii); *see RadLAX*, 132 S. Ct. at 2073.

[249] 11 U.S.C. §§ 362, 363, 364.

[250] *Id.* § 361.

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These two basic principles—value maximization and respect for nonbankruptcy distributional rules—reflect what might be called a minimalist approach to bankruptcy law. Bankruptcy law has important, but in some respects modest, aims: It provides a forum in which to vindicate creditors' and shareholders' state-law entitlements in an orderly and equitable fashion, and to enable the reorganization of financially distressed businesses if and when doing so is feasible and in creditors' best interests. It does not seek to impose its own vision of substantive fairness or to alter the rights established under nonbankruptcy law where doing so is not necessary to its procedural goals.

2. Abandoning Chapter 11's Basic Principles Is Bad Bankruptcy Policy

The Commission's Report reflects a very different vision of bankruptcy law, and the Commission's specific recommendations would fundamentally alter chapter 11's basic principles. But these principles have served the nation quite well. Casting them aside—especially in order to solve a problem that has not been proven to exist—would be a serious mistake.

a. The Commission's Approach

The Commission's Report would undermine each of the two basic principles underlying today's Bankruptcy Code. First, the Report rejects maximizing value for creditors as the principal goal of the chapter 11 process. Rather, the Report proceeds from the assumption that reorganization of the debtor is a goal in and of itself—one that can be balanced against creditors' interests and to which creditors' interests can be subordinated. Second, the Report would abandon the basic rule that bankruptcy distributes value in accordance with nonbankruptcy priorities, and enshrine its own distributional rules that it believes are more "subjectively fair"—rules that would pay junior creditors before senior secured creditors are paid in full, and would pay equity-holders before junior creditors are paid in full, contrary to the parties' bargains outside bankruptcy.

The Commission's mission statement sounded the theme: It promised that the Commission would propose reforms to chapter 11 "that will better balance the goals of effectuating the effective reorganization of business debtors … and the maximization and realization of asset values for all creditors and stakeholders."[251] The Report similarly states that its recommendations regarding secured creditors are intended to strike a "delicate balance … between the rights of secured creditors … and the reorganizational objectives of the estate."[252] One can "balance" the goal of reorganization against the goal of maximizing value for all stakeholders only if one believes that those are two separate, independent goals, and that it is sometimes proper to reorganize a company even if doing so harms creditors' interests. Although the Report does not acknowledge it, that is a dramatic departure from existing law. Chapter 11 as currently drafted does not contemplate reorganizing businesses where doing so will not maximize value for creditors; rather, reorganization is a way to maximize value. While it may often have beneficial effects that go beyond the stakeholders in the bankruptcy case, those effects by themselves are not a justification for abridging stakeholders' rights in bankruptcy.[253]

The Report's proposal regarding adequate protection reflects the Commission's contrary, and novel, view. That proposal is designed, in essence, to force secured creditors to subsidize debtors' efforts to reorganize. Specifically, as discussed in more detail below, the Commission proposes that, for purposes of adequate protection, secured creditors' collateral should be valued at its "foreclosure value"—the value it would realize in a hypothetical state-law foreclosure sale—not at its going-concern value, even if the debtor is operating as a going concern when it files for bankruptcy and expects to emerge from bankruptcy as a going concern.[254] The Commission's rationale is that "the use of a going concern valuation" for adequate protection purposes "may … reduc[e] significantly the debtor's financing and reorganization options."[255] The practical result of this proposal would be that debtors would

[251] *Report* at 3; *see id.* at 11.

[252] *Id.* at 72; *see id.* at 215.

[253] *See* Jackson, *supra* note 227, at 210 ("If it is important for firms to stay in business because of the jobs they save or because of their importance to their communities, that policy should be implemented as a matter of general law…. It is wrong to think that there should be an independent substantive policy of reorganization law to give firms breathing space or to reorganize them to preserve jobs" that can be implemented to the detriment of creditors).

[254] Report at 67-68.

[255] *Id.* at 71.

have a greater ability to use (and potentially dissipate or depreciate) collateral and to prime prepetition lenders' liens. Moreover, because the cost of using a secured creditor's collateral to finance a failed reorganization would be borne entirely by the secured creditor, debtors' management would have an incentive to make even inefficient investments in the hope that they might pay off, no matter how remote the possibility. In other words, the proposal would operate to encourage attempts to reorganize at the expense of maximizing value for creditors.

Likewise, the Report's proposals jettison the absolute priority rule and instead alter parties' nonbankruptcy priorities in the service of what the Commission views as a subjectively fairer outcome. The Report's proposal to provide out-of-the-money junior creditors with the "redemption option value" of their claims, thus paying junior creditors before senior creditors are paid in full, is an example. Another example is the Report's proposal to permit the owners of SMEs to retain a 15% ownership interest in, and essentially full control over, the enterprise for several years post-bankruptcy, even when creditors have not been paid. In both instances, the Report would alter nonbankruptcy priorities in bankruptcy, either based on a nebulous notion of fairness or out of a desire to encourage SMEs great use of chapter 11.

In many ways, the Commission's proposals to depart from absolute priority are a reprise of the debate that took place in the 1990s about the revisions to Article 9 of the Uniform Commercial Code. At that time, a number of commentators questioned whether secured creditors should be permitted to take a blanket lien on a borrower's assets and advocated for a "carve-out" for unsecured creditors. For instance, Elizabeth Warren argued that borrowers should not be permitted to encumber more than 80% of their assets, to ensure that unsecured creditors—including nonconsenting creditors such as tort claimants—had some assets from which to recover on their claims.[256] A number of others endorsed such an approach.[257] Others opposed a carve-out, arguing that restrictions on secured credit would impede borrowers' flexibility and make them less likely to survive outside bankruptcy, and that there were ways to deal with the problem of nonconsenting unsecured creditors (such as tort claimants) without creating a carve-out for all unsecured creditors.[258] As discussed above, *supra* Part II.A.1, that debate was ultimately resolved in favor of permitting borrowers to encumber substantially all their assets, resulting in an increased flow of secured credit to non-investment-grade borrowers. The Commission has nonetheless seemingly revived the view that secured credit should be restricted and incorporated that view into its proposals regarding bankruptcy reform, privileging its own view of a fair distributional scheme over the view legislators chose in adopting revised Article 9.

b. The Flaws in the Commission's Approach

Although the Commission's approach to bankruptcy reform is well-intentioned, in our view its decision to abandon basic bankruptcy principles will ultimately prove harmful. Substituting the Commission's vision for parties' nonbankruptcy entitlements undermines, rather than serves, the objective of fairness; it promotes forum-shopping; and it diminishes the clarity that is so necessary to commercial law.

First, while bankruptcy law is deeply concerned with fairness, it does not typically attempt to reallocate parties' nonbankruptcy rights based on a view that some other allocation would be "fairer." Bankruptcy's concern is a fair *procedure* for vindicating rights that are governed by nonbankruptcy law. Chapter 11 is thus designed to ensure that all stakeholders have a fair opportunity to negotiate the best way to maximize the value of the estate and to assert their state-law rights to a share of that value, and to ensure that creditors that are similarly situated are given equal treatment. Put simply, enforcing the bargains parties made outside bankruptcy is fair. To replace those bargains with a different allocation of value that lacks an objective referent, but is instead grounded only in the Commission's "subjective" intuitions does not comport with bankruptcy laws vision of fairness.

*Second***,** as the Supreme Court observed in *Butner*, altering the treatment of property interests in bankruptcy promotes "uncertainty," encourages "forum-shopping," and grants parties "windfall[s] merely by reason of the

[256] Elizabeth Warren, *An Article 9 Set-Aside for Unsecured Creditors*, 51 Consumer Fin. L. Q. 323, 323 (1997).

[257] *See, e.g.*, Kenneth N. Klee, *Barbarians at the Trough: Riposte in Defense of the Warren Carve-Out Proposal*, 82 Cornell L. Rev. 1466, 1468 (1997).

[258] *See, e.g.*, Jeffrey S. Turner, *The Broad Scope of Revised Article 9 Is Justified*, 50 Consumer Fin. L. Q. 328, 328-31 (1996); James J. White, *The Slippery Slope to Bankruptcy: Should Some Claimants Get a "Carve-Out" from Secured Credit?*, 7 Bus. L. Today 33, 33, 37-39 (1998); William J. Woodward, Jr., *The Realist and Secured Credit*: *Grant Gilmore, Common-Law Courts, and the Article 9 Reform Process*, 82 Cornell L. Rev. 1511, 1512 n.5 (1997) (listing letters written criticizing the Warren proposal).

happenstance of bankruptcy."[259] The core function of bankruptcy, again, is to solve the collective-action problem created by multiple creditors and enable the result that is best for the stakeholders as a group. When bankruptcy becomes an alternative distributional regime, rather than a procedure for enforcing the rights and priorities for which the parties bargained outside bankruptcy, parties have incentives to opt into (or seek to evade) bankruptcy to serve their own ends, rather than the group's, and bankruptcy's core function is undermined.[260]

That is why bankruptcy reform is not the place to revive the debates over the desirability of secured credit. The legislators who adopted revised Article 9 resolved the question of the proper balance between providing ready access to secured credit to help businesses succeed, on the one hand, and preserving assets for unsecured creditors in the event those businesses failed, on the other. And however one views that resolution—whether one believes it was right or wrong—it should govern in bankruptcy. Indeed, even those who advocated restricting secured credit during the Article 9 debates recognized that the desirability of secured credit was not a question of bankruptcy law and that having different distributional schemes inside and outside bankruptcy risked giving rise to forum-shopping: Unsecured creditors "would have a powerful incentive to put a non-paying business into bankruptcy where otherwise-encumbered assets would become available, rather than working outside bankruptcy to collect against their debtors."[261] Bankruptcy law respects nonbankruptcy priorities precisely to avoid such forum-shopping and the distorting effect it would have on the bankruptcy process.

Third, such an ad hoc approach threatens to damage the basic fabric of the Bankruptcy Code. The existing Code is founded on a relatively small number of core principles that establish a coherent framework for resolving new questions raised by changes in chapter 11 practice and the broader economy. That promotes certainty and predictability, elements that are crucial in any commercial law and to the broader markets that operate against the backdrop of those laws. By contrast, a system of bankruptcy laws based on balancing of debtor and creditor rights to achieve "fair" results provides no principled basis for resolving new questions as they arise, leaving debtors, creditors, and bankruptcy judges to guess how any given dispute should be resolved in order to hew most closely to the vision of "fairness" and "balance" adopted in the law.

In short, the problem with many of the Commission's proposals lies not just in the specifics, but in the broader view of bankruptcy law that undergirds them. Below, we address some of the Commission's proposals for reform in detail. In considering those specific proposals, however, it is critical to bear in mind the success that the existing bankruptcy regime has enjoyed and the risks associated with replacing that regime with one that will cast aside its basic principles.

III. RESPONSES TO THE REPORT'S PROPOSALS

A. Adequate Protection

From secured creditors' perspective, the Commission's recommendation to curtail secured creditors' right to adequate protection is perhaps the single most important and troubling proposal in the Report. Under current law, secured creditors are entitled to the full value of their collateral in bankruptcy. Indeed, that has always been a basic principle of bankruptcy. The Report's adequate protection proposal, however—because it limits the right to adequate protection to the "foreclosure value" of the collateral—threatens to reduce secured creditors' ultimate recoveries *below* the true value of their collateral. It is also likely to lead to longer, costlier, and less efficient bankruptcy cases.

1. Existing Law

Chapter 11 gives debtors an important and powerful tool: the ability to keep possession of and control over a secured creditor's collateral during the chapter 11 case even after defaulting on the underlying loan. Chapter 11 thus allows the debtor to continue using a secured creditor's collateral during the bankruptcy so that it can maintain operations, and, potentially, craft a plan of reorganization in which the collateral becomes the property of the

[259] *Butner*, 440 U.S. at 54-55.

[260] Jackson, *supra* note 227, at 21.

[261] Warren, *supra* note 256, at 324; *see also id.* ("Bankruptcy is a second best solution [because] the phenomenon at issue is not a bankruptcy problem but a problem of secured lending.").

reorganized debtor, which can then use it as part of a going concern.

To ensure that a secured creditor gets the benefit of the bargain it struck outside bankruptcy, however, the Bankruptcy Code provides that the creditor must receive "adequate protection" against depreciation in the value of its collateral during the bankruptcy case.[262] A secured creditor is entitled to adequate protection if the automatic stay prevents it from exercising its rights to the collateral; if the debtor proposes to use, sell, or lease the collateral; or if the debtor proposes to use the collateral as security for new debt.[263] Adequate protection may take the form of (1) "cash payments … to the extent that … [the debtor's] use … results in a decrease in the value of such entity's [*i.e.*, the creditor's] interest" in the collateral; (2) "an additional or replacement lien to the extent that [the debtor's] use … results in a decrease in the value of such entity's interest" in the collateral; or (3) "such other relief … as will result in the realization … of the indubitable equivalent of such entity's interest" in its collateral.[264] An oversecured creditor may also be found to be adequately protected by virtue of its equity "cushion"—that is, the difference between the value of its collateral and the value of its claim—if the court concludes that the cushion is sufficient to compensate for any decrease in the collateral's value.[265] Whatever its form, the purpose of adequate protection is to ensure that the creditor receives the full value of its collateral (up to the amount of its claim). As the Code's legislative history explains, the "concept [of adequate protection] is derived from the Fifth Amendment protection of property interests. … Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in *value* essentially what he bargained for."[266]

The question the Commission's proposal addresses is how to value the creditor's interest in its collateral for purposes of adequate protection. Under current law—and under the Commission's proposal—when a secured creditor's collateral is sold as part of a going concern, or will be retained and used as part of a reorganized business under a plan, the creditor is entitled to receive the full going-concern value (or what the Commission calls "reorganization value") of its collateral. Indeed, the Bankruptcy Code instructs that the value of a creditor's secured claim is "the value of such creditor's interest" in its collateral, and that "such value shall be determined in light of … the proposed disposition or use of such property."[267] The Supreme Court has accordingly held that if collateral is being used as part of a going concern, the secured creditor cannot be forced to accept the collateral's liquidation value under a plan.[268]

As a logical matter, where the intention is to sell the business as a going concern or to reorganize it, the creditor should thus be entitled to adequate protection of the going-concern value of its collateral as of the petition date. The statute reflects that; the Supreme Court has explained that the phrase "value of such entity's interest" in its collateral in the adequate protection provision has the same meaning as the phrase "value of such creditor's interest" in § 506(a), which governs valuation of secured claims.[269] As one scholar has explained, the better view of current law is that "a going-concern valuation [is] necessary for adequate protection purposes … at least when the debtor plan[s] a going-concern sale from the start. If the debtor proposes to keep the assets intact, it cannot use a different and lower value for purposes of adequate protection."[270]

2. The Commission's Proposal

The Commission's Report proposes that secured creditors receive adequate protection based on the "foreclosure value" of their collateral rather than the collateral's value as part of a going concern. "Foreclosure

[262] 11 U.S.C. § 361.

[263] 3 *Collier on Bankruptcy* 361.02; *see* 11 U.S.C. §§ 362(d)(1); 363(e); 364(d).

[264] 11 U.S.C. § 361.

[265] *See, e.g.*, *In re AMR Corp.*, 490 B.R. 470, 478 (S.D.N.Y. 2013); *Collier on Bankruptcy* 361.03[1].

[266] H.R. Rep. No. 95-595, at 339 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6295 (emphasis added).

[267] 11 U.S.C. § 506(a).

[268] *Assocs. Commercial Corp. v. Rash*, 520 U.S. 953, 962-63 (1997) (discussing chapter 13 plan confirmation).

[269] *See United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 372 (1988); *accord In re Residential Capital, LLC*, 501 B.R. 549, 592 (Bankr. S.D.N.Y. 2013) ("*ResCap*"); *see also In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 74 (1st Cir. 1995) ("[A] valuation for [adequate protection] purposes necessarily looks to § 506(a) for a determination of the amount of a secured claim.").

[270] Douglas G. Baird, *The Rights of Secured Creditors after* ResCap, 2015 U. Ill. L. Rev. 849, 854; *see also ResCap*, 501 B.R. at 591-95 (holding that where going-concern sale was contemplated, proper value for adequate protection purposes was going-concern value, not foreclosure value, of collateral); *but see id.* at 594 n.33 (listing, although disagreeing with, cases that use liquidation value for purposes of adequate protection).

value" is defined as the value a secured creditor would receive "upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law"—but without taking into account the secured creditor's right to credit-bid at such a sale.[271] The Report further proposes that, if there is a difference between the value collateral would realize at such a foreclosure sale and the value it would realize at a sale under § 363 of the Bankruptcy Code, that "cushion" can constitute adequate protection.[272]

The Report explains that the "decision to use foreclosure value [for purposes of adequate protection] is an integral part of the delicate balance the Commission struck between the rights of secured creditors, on the one hand, and the reorganizational objectives of the estate, on the other hand."[273] As noted above, the Report does recommend that a secured creditor receive the going-concern value of its collateral following a sale or plan confirmation (valued as of the sale or effective date of the plan).[274] The Report posits, however, that "[t]he use of a going concern valuation" for adequate protection purposes "may … reduc[e] significantly the debtor's financing and reorganization options."[275] The "balance" the Commission proposes, the Report asserts, "would enhance a debtor's ability to obtain much-needed liquidity early in the case while allowing the senior creditor to benefit from the reorganized debtor's continued use of collateral in the ongoing business by receiving the value of its collateral on an enterprise or going concern basis later in the case."[276] In other words, the Report advocates that secured creditors' right to the full value of their collateral should yield to the interest in providing the debtor greater flexibility in the use of its assets and in obtaining debtor-in-possession financing during the period in which it is attempting to reorganize.

The upshot of the Report's proposal is that debtors will have greater ability to use (and potentially dissipate or depreciate) collateral and to prime prepetition lenders' liens, to the detriment of secured creditors. Take the example of a senior secured creditor with a $50 million claim secured by a blanket lien on all the debtor's assets. Sold as a going concern, the debtor's business is worth $50 million. But for a variety of practical reasons, including the difficulty of obtaining the requisite consents to the assignments of contracts in an asset sale under state law, the value of the business when sold in a state-law foreclosure proceeding might be less. In this case, posit that the foreclosure value is only $30 million. Under the Report's proposal, the debtor could obtain $10 million in postpetition financing from a new lender by giving it a lien superior to the prepetition lender's lien, and the remaining $10 million in value would likely be deemed adequate protection of the prepetition lender's interest in its collateral.[277] In that situation, even if the going-concern value of the business did not decline at all during the bankruptcy case, the prepetition lender would be able to realize only $40 million of that value at the end of the case, rather than the $50 million to which it would otherwise have been entitled. Similarly, the debtor could dissipate substantial value during its attempts to reorganize, and the secured creditor would be essentially without recourse.[278]

3. Implications of the Commission's Proposal

The Commission's proposal is flawed both as a practical and as a legal matter. Practically, the proposal will (as it is intended to do) significantly change the dynamic of chapter 11 cases, but not for the better. As the Commission hopes, cutting back secured creditors' right to adequate protection will put greater control of the chapter 11 process in debtors' hands; but by doing so, it will lead to inefficiencies and give control to a party whose incentives may not be aligned with what is best for the estate as a whole. Legally, the Commission's proposal misapprehends the nature of secured creditors' rights in their collateral. Secured creditors do not lend based on the "foreclosure" value of their collateral, and their state-law right is not to the "foreclosure" value of their collateral,

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[271] Report at 67.

[272] *Id.* at 67-68.

[273] *Id.* at 72; *see also id.* at 215 ("[V]aluing a senior creditor's collateral at (i) foreclosure value … for purposes of adequate protection, and (ii) reorganization value … for purposes of distributions" provides a "balance [that] enhance[s] a debtor's ability to obtain much-needed liquidity early in the case.").

[274] *Id.* at 72, 207.

[275] *Id.* at 71.

[276] *Id.* at 215.

[277] An equity cushion of 20% or more of the collateral's value has generally been deemed sufficient to constitute adequate protection. *See, e.g.*, *In re James River Assocs.*, 148 B.R. 790, 796 (E.D. Va. 1992).

[278] The Report suggests that a court could provide in the adequate protection order that if "reorganization efforts fail" or there is cause to lift the automatic stay, the secured creditor would have the right to force a § 363 sale. Report at 68, 72. But that would not compensate the secured creditor for value already lost either through a priming lien or through depreciation.

but to the collateral itself or any value derived from it, up to the amount of their claim. The Commission's proposal would break that basic bargain.

a. Practical Implications

In current chapter 11 practice, a secured creditor's right to adequate protection ensures that the secured creditor has a say over what happens to the collateral in which it has a property interest. Take, for example, the case about which the Commission appears to be most concerned—one in which a debtor grants its prepetition lender a blanket lien on all of its assets and then enters bankruptcy with an enterprise value that is less than the outstanding loan balance.

In those circumstances, it is likely true (as the Commission says) that the secured creditor has substantial control over the conduct of the bankruptcy case. Because of the secured creditor's entitlement to adequate protection, the practical reality is that the debtor will be required to seek and obtain the secured creditor's consent to operate its business in chapter 11. The cash generated by the debtor's business operations is presumably the secured creditor's cash collateral, and the debtor can use that cash to continue its operations only if it provides the creditor adequate protection against the potential loss of the cash. Likewise, the debtor can obtain new postpetition financing from a different lender by "priming" the prepetition secured creditor's loan only if it provides adequate protection against the diminution in value of the creditor's collateral resulting from the priming. And finally, insofar as continued operations impose a risk that the debtor's assets would diminish in value, the secured creditor is entitled to adequate protection against those risks. Where a creditor holding a blanket lien is undersecured, however, providing adequate protection will be difficult or impossible, and if the debtor cannot provide adequate protection, it will not be able to take any of these actions without the secured creditor's consent. For these reasons, the secured creditor has substantial leverage in the bankruptcy case. Even if the prepetition lender is not itself extending new postpetition credit, its right to adequate protection (in cases in which the assets are fully liened-up and the loan is underwater) effectively means that the debtor is required to operate its business within the limits of a budget, and in accordance with a timetable, to which the secured creditor has consented.

The Commission's proposal on is designed to shift that control from the secured creditor to the debtor. The premise of the adequate protection proposal is that the "foreclosure value" of the debtor's assets is likely to be less than the value of those assets on a reorganization basis. Restricting a secured creditor's right to adequate protection to the foreclosure value of its collateral frees up the difference for the debtor's use during the bankruptcy case. Thus, the debtor may be able to prime the prepetition secured creditor's loan, or use its cash collateral, without the secured creditor's consent and without the need to protect the reorganization value of the collateral. As Commissioners Donald Bernstein and James Millstein put it, the proposal will "reduce secured creditors' leverage to block post-petition financing or the use of cash collateral by withholding their consent."[279] Debtors will thus have the necessary "flexibility" to make business choices regarding the use of a secured creditor's collateral without requiring the secured creditor's consent.

Put differently, secured creditors will be forced to finance the debtor's attempt at reorganization. Because the debtor will be using the secured creditor's collateral, the Report's proposals would misalign the parties' incentives: The secured creditor will bear all the losses from any erroneous decisions, while the debtor's management and junior creditors will have nothing to lose. As discussed above, *see supra* Part II.A.2, this scenario creates an incentive for the debtor to engage in inefficient investment decisions—those with a low chance of a high payoff—rather than to make efficient investment decisions that are most likely to maximize the value of the estate for the benefit of all constituencies. The corollary is that bankruptcy cases will be more prolonged and costlier.

The additional valuation required for the court to determine the "foreclosure value" of a creditor's collateral in a hypothetical sale under state law will also add complexity and expense. It is unclear how courts would conduct such a counterfactual valuation, especially given that a creditor would typically have the right to credit-bid for its collateral and thus have a voice in determining the collateral's value, but the commission's proposal requires courts to ignore that right. As one commentator put it, "the party who argues in favor of valuing the secured creditor's right by some hypothetical disposition that never happened should bear the burden of explaining … why taking everyone down such a rabbit hole makes sense."[280]

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[279] Donald Bernstein & James Millstein, *ABI Commission: Redemption Option Value Explained,* Am.Bankr.Inst.J.,June 2015, at 10, 10-11.

[280] Baird 2015, *supra* note 270, at 854. The Commission's proposal to permit the difference between the value of the creditor's collateral in a state-law foreclosure sale and a § 363 sale in bankruptcy to serve as adequate protection adds yet more complexity, since a court determining whether a secured creditor is adequately protected under that rule would have to conduct *two* hypothetical valuations.

To be sure, to the extent the debtor's reorganization is successful, the Commission's proposal would require that the secured lender receive the reorganization value of its collateral. The proposal accomplishes that by providing that when a secured loan is "crammed down" under a plan of reorganization, the value of the collateral is determined on a reorganization—not a foreclosure—basis. But if the reorganization were unsuccessful, the downside would be borne by the secured creditor, who would be unable to recoup the value of its collateral lost during the failed reorganization attempt.

This proposal, if adopted, would have serious effects on the credit markets. Lenders do not extend credit based on the "foreclosure" value of collateral. Rather, in determining the likely recovery given default, lenders and credit ratings agencies take into account the bankruptcy process and the means for disposing of assets through bankruptcy that might lead to a higher recovery than state-law foreclosure.[281] Moreover, lenders who obtain blanket liens on substantially all of a company's assets do so precisely in order to be able to access the going-concern value of the company in the event of default. As one industry participant explained:

> Lenders who provide both asset-based loans and secured cash flow loans typically take blanket security interests in all assets of the borrower. The total leverage … is generally limited by a metric that proxies for the "going concern value" of the company…. This structure makes sense from an underwriting perspective, as the lender's exit in a downside scenario involves selling the company as a whole. However, this logic must be reevaluated in a world where adequate protection is calculated at "foreclosure value."[282]

Under the Commission's proposal, which would give debtors the ability to access and deplete going-concern value, creditors would not be able to recover what they bargained for. And, as discussed above, *see supra* Part 11,A,2, these changes would necessarily affect the pricing and availability of credit: "If the adequate protection recommendation is implemented, it is not difficult to predict the lending market's reaction. Secured lenders would underwrite loans that provide less incremental liquidity, as advances would be tied to 'foreclosure value' of collateral…. In addition to liquidity constraints, new loans would have higher pricing and [a] more restrictive structure."[283] Saying that "the market will adjust" is not a sufficient answer. Such an adjustment would be likely to harm the companies that most need credit:

> Lenders will find ways to operate in most environments, taking protective measures as to liquidity, pricing, and structure. However, retailers in distress or turnaround mode will not enjoy the same fate. The liquidity runway needed to turn around a retail business will be cut short. As a result, retailers will face more bankruptcies, restructurings, and liquidations—and these events will arise sooner than under the existing bankruptcy framework.[284]

Of course, such changes would not affect retailers alone, but all distressed companies in need of readily accessible and affordable credit to stave off a liquidity crisis or invest in their businesses.

b. Legal Flaws

The Report's proposal to modify adequate protection is also legally flawed because it rests on a contested, and we believe erroneous, understanding of the nature of a security interest. The Report argues that a secured creditor's nonbankruptcy entitlement is "the net value that the secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral to a third party."[285] The Report asserts that providing the secured creditor that "foreclosure value" "preserves the value of the secured creditor's interest under its prepetition bargain with the debtor."[286] But the Report never explains the basis for its assertion that, under

[281] *See, e.g.*, Daniel P. Wilansky, *Chapter 11 Reform: Proposed 'Adequate Protection' Recommendation Hurts Retailers*, ABL Advisor (Apr. 6, 2015) at 1, available at www.abladvisor.com/ articles/6752/chapter-11-reform-proposed-adequate-protection-recommendation-hurts-retailers (explaining that asset-based loans to retailers are structured based on the assumption that inventory will be sold in an orderly fashion in bankruptcy, not through a state-law foreclosure sale).

[282] *Id.* at 2.

[283] *Id.*

[284] *Id.*

[285] Report at 67.

[286] Report at 71 n.284 (citing Edward Janger, *The Logic and Limits of Liens*, 2015 U. Ill. L. Rev. 589).

state law, secured creditors are entitled only to the value they would receive in a foreclosure sale of their collateral to a third party. In fact, that is incorrect. It reflects a misunderstanding of the scope of remedies available to secured creditors under state law. It also conflates secured creditors' nonbankruptcy rights with the remedies that might as a practical matter be available to them; as discussed below, only the former should be relevant to bankruptcy law.

i. Secured Creditors' Rights and Remedies Outside Bankruptcy

Simply put, outside bankruptcy, a secured creditor has the right to be paid in full or to foreclose and take its collateral, up to the amount of the creditor's claim. As Judge Learned Hand said long ago, a secured creditor is entitled to "to get [its] money or at least the property" securing the debt.[287] Put differently, a senior secured creditor has the first priority, ahead of unsecured creditors and the debtor, in whatever value is realized from the collateral securing its claim.

Article 9 of the Uniform Commercial Code—some form of which has been adopted by every state—codifies that common-law understanding. Article 9 provides that a debtor may grant a security interest in most types of personal property or fixtures.[288] A security interest is "an interest in personal property,"[289] and it "attaches to any identifiable proceeds of collateral,"[290] which are broadly defined to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral" and "whatever is collected on, or distributed on account of, collateral."[291]

A security interest is thus a property right (albeit not fee ownership) in the collateral and its proceeds. General unsecured creditors, by contrast, have no property rights in the collateral. Even if such a creditor obtains a judgment lien, a perfected security interest has priority over subsequent lien creditors.[292] Thus, a creditor holding a perfected security interest has a property interest in the collateral that is enforceable as against the debtor in the event of default and that is senior to any subsequent lien creditor.

Article 9 also provides a remedy in the event of default: A secured creditor may sell its collateral and apply the proceeds (after payment of sale expenses) to satisfy its debt in full, before any remaining proceeds may be paid to junior lienholders or to the debtor.[293] The purpose of that remedy is to enforce the secured creditor's underlying right to recover *all* value realized from its collateral, until it has been paid in full, before any such value may be paid to junior creditors. Thus, if a third party seeks to buy the collateral at a public foreclosure sale for less than the collateral is worth, the secured creditor has the right to credit-bid at the sale and to purchase the collateral itself.[294] This right ensures that the secured creditor cannot be forced to relinquish its collateral for anything less than its full value. It can instead take back its collateral, acquiring by purchase "all of the debtor's rights in the collateral,"[295] and thereafter realize the property's value as any other owner would, whether through a subsequent (non-foreclosure) sale or through receipt of income from the property.

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[287] *Murel.*, 75 F.2d at, 942; *see also, e.g.*, *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) ("[T]he creditor's lien stays with the real property until the foreclosure. That is what was bargained for by the mortgagor and the mortgagee."); *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 575-576 (1935) ("The right of the mortgagee to insist upon full payment before giving up his security has been deemed of the essence of a mortgage.").

[288] *See* U.C.C § 1-201(35) (definition of "security interest"); § 9-102(12) (definition of "collateral"); § 9-109 (scope of Article 9); § 9-203 (attachment and enforceability of security interest).

[289] *Id.* § 1-201(35).

[290] *Id.* § 9-315(a)(2).

[291] *Id.* § 9-102(64).

[292] *See id.* § 9-317(a)(2) (providing that a security interest "is subordinate to the rights of … a lien creditor" only if the security interest is unperfected and a financing statement has not been filed); *id.* § 9-102(52) (defining "lien creditor" to include a "creditor that has acquired a lien on the property involved by attachment, levy, or the like"); *id.* § 9-324 Official Comment No. 4 ("Under Section 9-317(a)(2), a [perfected] security interest is senior to the rights of a person who becomes a lien creditor"); *see also* 9-322(a)(1) ("Conflicting perfected security interests … rank according to priority in time of filing or perfection."); *id.* § 9-322(a)(2) ("A perfected security interest … has priority over a conflicting unperfected security interest[.]").

[293] *See id.* § 9-610, § 9-615(a), (d).

[294] *See id.* § 9-610(c).

[295] *See id.* § 9-617(a).

Moreover, Article 9's sale remedy is not the exclusive remedy that state law affords secured creditors. Article 9 provides that "a security interest … continues in collateral notwithstanding any sale, lease, license, exchange, or other disposition thereof unless the secured party authorized the disposition free of the security interest."[296] Thus, if the collateral is sold to a third party outside a foreclosure sale, in a context in which the secured creditor may not have had the right or opportunity to bid for its collateral, the creditor cannot be forced to relinquish its security interest in the collateral. In such cases, "[t]he secured creditor may claim both any proceeds and the original collateral but, of course, may have only one satisfaction."[297] Thus, Article 9 provides that "after default, a secured party may take any proceeds to which the secured party is entitled,"[298] and apply those proceeds until its debt is paid in full, before any remaining proceeds may be paid to junior creditors or the debtor.[299]

Indeed, the UCC provides that a secured creditor is not limited to the remedies afforded by Article 9, and that "[a] secured creditor may reduce a claim to judgment, foreclose, or otherwise enforce the claim, security interest, or agricultural lien by any available judicial procedure."[300] The official comments explain that Article 9 is designed to permit a secured creditor to enforce its security interest "by any available procedure outside this Article under applicable law," thus endorsing the use of any available mechanism to realize upon collateral.[301] So long as the sale is "commercially reasonable," Article 9 provides an extremely broad and flexible process in which "a secured party may dispose of collateral by public or private proceedings, by one or more contracts, as a unit or in parcels, and at any time and on any terms"—all with a view to maximizing the value realized from the collateral.[302] For that reason, the Report's "distinction between values realized in bankruptcy and out is overdrawn. Even if the proper benchmark is the value of the senior lender's nonbankruptcy right, it is a mistake to think that the value of this right is the modest amount realized in a foreclosure. … Especially when only institutional debt is to be restructured, creditors outside of bankruptcy can effect going-concern sales of entire firms quite easily."[303]

In short, Article 9 permits debtors to grant creditors security interests in a broad range of assets, and once perfected, a security interest gives a creditor a property interest in the collateral itself. As a result of that property interest, the secured creditor has priority over other creditors and the debtor in any value derived from its collateral. This understanding of secured creditors' rights informs the current Bankruptcy Code's approach to adequate protection, which, as described above, is intended to protect creditors' rights in the full value of their collateral.

ii. The Commission's View Misapprehends The Secured Creditor's Right

As noted, however, the Commission takes a different view of secured creditors' rights, relying on the premise that secured creditors are entitled only to what they would receive in a state-law foreclosure sale to a third party. That premise not only misunderstands the breadth of remedies available to a secured creditor under state law, but also conflates the creditor's underlying right with the remedy the creditor would be likely to obtain, as a practical matter, in the event of default. The law review article that the Report cites makes that point explicit, observing: "One might view secured credit solely as a remedy; the secured creditor has chosen secured credit to ensure an alternate source of recovery. They are therefore entitled to at least what they would have recovered had they exercised their rights outside of bankruptcy."[304]

But secured credit is not "solely … a remedy," let alone solely the remedy of a foreclosure sale to a third party. A security interest is a form of priority in value derived from the creditor's collateral. What it means to have

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296 *See id.* § 9-315(a)(1).

297 *See id.* § 9-315 Official Comment No. 2.

298 *Id.* § 9-607(a)(2).

299 *Id.* § 9-608(a).

300 *Id.* § 9-601(a)(1).

301 *See id.* Official Comment No. 6.

302 *See id.* § 9-610(b); *see also id.* Official Comment No. 2 ("This section encourages private dispositions on the assumption that they frequently will result in higher realization on collateral for the benefit of all concerned."); *id.* Official Comment No. 3 ("This Article does not specify a period within which a secured party must dispose of collateral. This is consistent with this Article's policy to encourage private dispositions through regular commercial channels. It may, for example, be prudent not to dispose of goods when the market has collapsed.").

303 Baird 2015, *supra* note 270, at 853 (citing Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255, 256 (2009)).

304 Edward Janger, *The Logic and Limits of Liens*, 2015 U. Ill. L. Rev. 589, 600.

a security interest is that the secured creditor is entitled to recover any value realized from the collateral, up to the amount of the creditor's debt, before unsecured creditors or the debtor are entitled to any of that value. State law does not limit the secured creditor to receiving only what could be obtained in a foreclosure sale. Article 9 does indeed, as discussed above, provide a remedy by which a secured creditor may sell its collateral and apply the proceeds to satisfy its debt. But it also permits the secured creditor to pursue any other available remedy to that end. And none of these remedies limits the underlying right of a secured creditor to recover all value realized from its collateral, until it has been paid in full, before any value may be paid to junior stakeholders. Rather, the essence of a security interest is that the secured creditor has the right to recover the full value of its collateral to satisfy its debt—whether by taking the proceeds of a sale to a third party or, failing that, by taking the collateral itself to ensure that all of its value is dedicated to repayment of the secured creditor's debt.

The Commission apparently takes the view that because chapter 11 maximizes the value of the estate's assets, any value in a secured creditor's collateral that might not have been realized, as a practical matter, outside chapter 11 belongs to the estate as a whole. But the Report never explains why the fact that chapter 11 maximizes assets' value should be a justification for reordering the parties' nonbankruptcy priorities in those assets. As discussed above, *see supra* Part II.C.1, the better view is that chapter 11 is designed to maximize the value of the estate for the benefit of all constituencies, but not to alter nonbankruptcy distributional priorities.

In many respects, the Commission's proposal regarding adequate protection—which will result in some secured creditors recovering less than the value of their collateral in bankruptcy—and related proposals are grounded in the same concerns about secured credit that drove the debate over Article 9 discussed above, *see supra* Part II.C.2. It is "subjectively unfair," the Commission believes, for secured creditors to capture all the value of a firm's assets, even if the creditor has a valid lien on those assets. But that policy debate has already been resolved. It is inappropriate to try to alter the outcome of that debate by amending the Bankruptcy Code. Whatever one thinks state-law entitlements should be, there are good and sound reasons why bankruptcy law should respect, rather than discard, those state-law entitlements.

* * *

Of all the Commission's proposals, its attempt to gut adequate protection is among the most problematic. It is intended to (and would) reduce secured creditors' recoveries and reduce their ability to exercise control over the use of their collateral. And the "flexibility" the proposal is intended to give debtors essentially amounts to allowing debtors to make bankruptcy cases more protracted and expensive, depriving secured creditors of both the value and the control over their collateral to which they would otherwise be entitled.

B. Recognition of Security Interests in Proceeds of Collateral (Section 552)

The Report proposes to provide debtors and junior creditors with a greater ability to claim the postpetition proceeds of secured creditors' collateral, by expanding the "equities of the case" exception in § 552(b) of the Bankruptcy Code and by prohibiting the debtor from waiving its right to invoke that provision.

1. Existing Law

Section 552 of the Bankruptcy Code governs the postpetition effect of a security interest. Section 552(a) establishes the general rule that property the estate acquires after the bankruptcy filing is not subject to any lien resulting from a prepetition security agreement.[305] Section 552(b) then provides, as an exception to that general rule, that if a prepetition security agreement creates a security interest in property the debtor acquired before bankruptcy and the "proceeds, products, offspring, or profits" of such property, then the security interest extends to proceeds acquired by the estate after the bankruptcy filing "to the extent provided by such security agreement and by applicable nonbankruptcy law."[306]

In essence, § 552(a) provides that a security interest in "after acquired" property is cut off on the petition date, so that the creditor's lien does not attach to any new property that the bankruptcy estate acquires after the bankruptcy filing. At the same time, however, § 552(b) provides that a security interest in the "proceeds" of any

[305] 11 U.S.C. § 552(a).

[306] *Id.* § 552(b)(1).

collateral that the secured creditor held as of the petition date continues to attach to any such proceeds that the bankruptcy estate acquires thereafter. That rule preserves a secured creditor's basic entitlement to the full value of the collateral securing its claim at the time of the bankruptcy filing, even if that collateral changes form during the bankruptcy case. For example, a secured creditor's prepetition collateral may consist of inventory that is sold in the ordinary course of business during the bankruptcy proceedings, or an entire business unit that is sold out of the ordinary course of business pursuant to § 363 of the Bankruptcy Code. Section 552 ensures that when the estate uses or sells the secured creditor's prepetition collateral during the bankruptcy proceedings, the secured creditor's rights to the proceeds of its collateral under its security agreement and applicable nonbankruptcy law will be respected in bankruptcy.[307]

The Report's proposals concern a narrow statutory exception to this basic rule that a secured creditor is entitled to the proceeds of its collateral. That exception—the "equities of the case" exception—provides that a security interest in the proceeds of prepetition collateral extends to postpetition proceeds of such collateral "except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise."[308]

Under existing law, the "equities of the case" exception has generally been limited to circumstances in which the bankruptcy estate expends unencumbered cash or other unencumbered property to enhance the value of the secured creditor's prepetition collateral. The exception thus permits courts to limit a secured creditor's security interest in the postpetition proceeds of its collateral to the extent that the value of those proceeds has been increased by the expenditure of unencumbered assets that would otherwise have been available to the estate and general unsecured creditors.[309]

On the other hand, the "equities of the case" exception generally does not apply where the estate has not expended unencumbered property to enhance the value of a creditor's prepetition collateral.[310] In those circumstances, the funds available to the estate and general unsecured creditors have not been diminished. And where the estate has not spent unencumbered funds to improve the value of the secured creditor's collateral, § 552 and the equities dictate that any appreciation in the value of that collateral during the bankruptcy proceedings—including any proceeds realized from such collateral—should accrue to the secured creditor, consistent with its rights under nonbankruptcy law.[311]

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[307] The Uniform Commercial Code generally provides that a security interest in collateral attaches to the identifiable "proceeds" of collateral, which is defined to include "whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral," "whatever is collected on, or distributed on account of, collateral," "rights arising out of collateral," and certain other claims or insurance for loss or damage to the collateral. *See* U.C.C. §§ 9-102(64), 9-203(f), 9-315(a).

[308] *See* 11 U.S.C. § 552(b)(1).

[309] *See In re Tower Air, Inc.*, 397 F.3d 191, 205 (3d Cir. 2005) (noting that the "equities of the case" exception is used where the "collateral … has appreciated in value as a result of the trustee's/debtor-in-possession's use of other assets of the estate" (internal quotation marks omitted)); *In re Cross Baking Co.*, 818 F.2d 1027, 1033 (1st Cir. 1987) ("[T]he 'equities of the case' proviso is a legislative attempt to address those instances where expenditures of the estate enhance the value of proceeds which, if not adjusted, would lead to an unjust improvement of the secured party's position" and "prejudic[e] the unsecured creditors"); *J. Catton Farms, Inc. v. First Nat'l Bank of Chicago*, 779 F.2d 1242, 1246 (7th Cir. 1985) ("The equity exception is meant for the case where the trustee or debtor in possession uses other assets of the bankrupt estate (assets that would otherwise go to the general creditors) to increase the value of the collateral."); *In re Village Properties, Ltd.*, 723 F.2d 441, 444 (5th Cir. 1984) (the exception's "purpose was to cover cases where an expenditure of the estate's funds increases the value of the collateral"); H.R. Rep. No. 95-595, at 376-77 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6332-33 (stating that the exception "is designed to cover the situation where the estate expends funds that result in an increase in the value of collateral. The exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the funds available for general unsecured creditors").

[310] *See Tower Air*, 397 F.3d at 205 (affirming denial of "equities of the case" exception because "assets of the estate were not used to increase the value of [the] collateral"); *In re Laurel Hill Paper Co.*, 393 B.R. 89, 93-94 (Bankr. M.D.N.C. 2008) (declining to apply "equities of the case" exception based on the "efforts" of the debtor's management that allegedly increased the collateral's sale price because no "unencumbered funds of the estate" "were spent to repair or otherwise make tangible improvements" to the collateral); *In re Muma Servs., Inc.*, 322 B.R. 541, 558-59 (Bankr. D. Del. 2005) (declining to apply "equities of the case" exception where "neither the Debtors nor the Trustee invested any unencumbered funds available to the general unsecured creditors to enhance the value of the assets which were sold" during the bankruptcy).

[311] *See Dewsnup*, 502 U.S. at, 417 ("Any increase … [in] valuation [of the collateral] during bankruptcy rightly accrues to the benefit of the [secured] creditor, not to the benefit of the debtor and not to the benefit of other unsecured creditors whose claims have been allowed and who had nothing to do with the mortgagor-mortgagee bargain.").

2. The Commission's Proposal

The Report recommends that the "equities of the case" exception be modified in two ways.[312] *First*, it proposes that "[a] trustee should not be required to establish an actual expenditure of funds to show that the estate enhanced the value of a secured creditor's collateral"; "[r]ather, … evidence of any value provided, obligation incurred, or other actions taken with respect to the collateral" should suffice.[313] Thus, "the trustee should be able to satisfy the equities of the case exception with evidence of the estate contributing value, whether through time, effort, money, property, other resources, or cost savings."[314] *Second*, it proposes that "[t]he trustee should not be able to waive … the equities of the case under section 552(b)."[315]

3. Implications of the Commission's Proposal

In our view, the Report's proposal should not be adopted.

a. "Equities of the Case" Standard

The Report's proposal to expand the "equities of the case" exception is designed, in essence, to give debtors greater ability to use the proceeds of secured creditors' collateral to fund their reorganization efforts and to distribute more value to junior stakeholders. By eliminating the requirement that the debtor show an actual expenditure of unencumbered property to improve the value of a secured creditor's collateral, the proposal would permit a debtor to assert that it enhanced the value of the collateral through any contribution of its "time," "effort," or "other actions taken with respect to the collateral," and that any post/petition increase in the value of that collateral should therefore belong to the estate. The practical result of this proposal is that a significant portion of increases in the value of the secured creditor's collateral during the bankruptcy case will go to the debtor's estate and junior stakeholders, not to the secured creditor, even where those increases are not the result of expending unencumbered assets that would have otherwise been available to unsecured creditors.

The proposal seemingly draws on the recent ruling in *ResCap*, discussed in the Report.[316] In that decision, a bankruptcy court held that a secured creditor—whose prepetition collateral included certain of the debtor's mortgage-servicing business assets, related goodwill, and any proceeds thereof—was not entitled to any proceeds from the sale of that business attributable to the business's goodwill. It reasoned that "even if [the secured creditor's] Collateral was used to generate goodwill" postpetition—*i.e.*, to increase the intangible value of the business after the bankruptcy filing—the secured creditor was not entitled to any of that value because "Debtor resources were used as well," including the debtor's "time, effort, and expense" in negotiating settlements of disputes relating to the business.[317] While the decision might be understood as resting on the secured creditors' failure as an evidentiary matter to identify the proceeds of their collateral,[318] it could be read more broadly to suggest that a secured creditor is not entitled to the postpetition proceeds of its collateral if any "Debtor resources"—including "time" and "effort"—are used to help realize those proceeds. That notion marks a significant departure from existing law.[319]

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[312] The Report also considered adopting a federal definition of "proceeds" for purposes of § 552, noting "the significant expansion of the definition of proceeds under state law since the enactment of the Bankruptcy Code in 1978" and that some commentators had posited that those changes "were designed primarily to alter bankruptcy law outcomes in favor of secured creditors." *See* Report at 230, 233. The Report notes that the Commission ultimately declined to adopt a federal definition, noting that "a federal definition of proceeds that conflicted with state law would create uncertainty and increase costs in secured credit transactions." *Id.* at 233. For the reasons discussed above, we agree with this conclusion, which is consistent with the Bankruptcy Code's basic principle that value is allocated in accordance with the priorities established by nonbankruptcy law.

[313] *Id.* at 230.

[314] *Id.* at 234.

[315] *Id.* at 230.

[316] *Id.* at 232-33.

[317] *See ResCap*, 501 B.R. at, 610-12 ("The Debtors did not merely take some JSN Collateral and convert it into goodwill without any other resources. That means that the goodwill is not the proceeds of JSN Collateral.").

[318] *See id.* at 612 ("Even if a portion of the goodwill was directly attributable to JSN Collateral, without any additional resources, the JSNs have failed to separate the value of that goodwill.").

[319] *See, e.g., In re Laurel Hill Paper Co.*, 393 B.R. at 93-94 (declining to apply "equities of the case" exception based on the "efforts" of the debtor's management to increase sale price of collateral where no "unencumbered funds of the estate" "were spent to repair or otherwise make tangible improvements" to the collateral); *see supra* Part III.B.1.

In recommending that this change be adopted, the Report asserts that it will strike a more "appropriate balance between the rights of secured creditors and the estate" and "promot[e] rehabilitation" by "provid[ing] the trustee with resources to help facilitate the debtor's reorganization."[320] Like many of the Report's proposals, this proposal is driven by the view that increased secured-creditor control has undermined the Bankruptcy Code's effectiveness and resulted in too few reorganizations and too little value distributed to unsecured creditors. The proposal to expand the "equities of the case" exception is another instance in which the Report seeks to scale back the rights of secured creditors in chapter 11 cases, in order to redress that perceived problem. Yet here, as elsewhere, the Report fails to cite any reliable empirical evidence demonstrating that increased secured-creditor control has undermined the chapter 11 process or that the current scope of § 552 and the "equities of the case" exception is in need of reform.

The proposal is also conceptually flawed. Underlying it is the notion that the debtor's "time" and "effort" are assets that belong to the estate and can be "expended" in a manner that enhances the value of collateral. As the Commission says, "[t]he basic premise should be that, if the estate creates value through any means during the chapter 11 case and such value enhances the secured creditor's collateral, the estate should receive the benefit of such value."[321] What this view elides is that the debtor is a corporation; the debtor *qua* debtor cannot expend "time" or "effort." Rather, the debtor can merely purchase that time or effort from individuals, presumably at a fair market price, and (to the extent that all of the debtor's assets are in fact subject to a valid lien—an assumption that will not always be true, and is perhaps more likely to be the case in some industries than others) will presumably use cash that represents the lender's collateral, or the proceeds thereof, to pay for that "time and effort." To the extent that the debtor's employees expend time and effort in a way that enhances the value of the secured creditors' collateral during the course of the bankruptcy case, the question should be whether the assets the debtor used to pay the employees were in fact the lender's collateral. If so, then any value generated by the time and effort expended by the workers represents the proceeds of the creditor's collateral. "If a secured creditor has a fully perfected security interest in everything of value to Firm, including all of its cash, any assets acquired post-petition are necessarily proceeds of its collateral. To be sure, the proceeds might have been derived in part from the work of Firm's employees, but this work was paid for with the cash in which the senior creditor had a security interest."[322] It is therefore wrong to say that "if the estate creates value through any means during the chapter 11 case," that value necessarily belongs to the estate.

Moreover, the Commission's proposal is likely to add complexity and expense to the chapter 11 process. By expanding the "equities of the case" exception to permit debtors to argue that their "time," "effort," or "other actions" improved the value of a secured creditor's collateral, the proposal would likely lead to litigation over the exception in more cases, since debtors will likely be able to point to expenditures of time or effort in many more cases than those in which they will be able to establish an actual expenditure of unencumbered property. In addition, determining whether a debtor's "time," "effort," or "other actions"—as opposed to a tangible expenditure of assets—enhanced the value of a secured creditor's collateral is likely to pose questions of proof that are more difficult, expensive, and time-consuming for parties and courts to litigate and resolve.

b. Waiver of the "Equities of the Case" Exception

The Report also recommends that debtors should be categorically barred from agreeing to waive the "equities of the case" exception (as well as the right to surcharge collateral under § 506(c), discussed below). The Report acknowledges that such waivers are often given in exchange for other benefits, such as "carve-out" agreements permitting the estate to use a portion of the secured creditor's collateral to pay for general administrative expenses or other claims.[323] But the Report expresses concern that the debtor may have "little bargaining leverage" and may not negotiate agreements that "always represent a good alternative for the estate."[324] Accordingly, it proposes an across-the-board ban prohibiting debtors from entering into such waivers in all cases.

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[320] Report at 232-34.

[321] *Id.* at 234.

[322] Baird, *2015, supra* note *270*. at 858; *but see* Michelle Harner, *The Value of Soft Variables in Corporate Reorganizations*, 2015 U. Ill. L. Rev. 509, 519 (arguing that secured creditors' prepetition security interests should not extend to postpetition value attributable to "soft variables" such as "people," "synergy," and "relationships").

[323] Report at 228, 238.

[324] *Id.* at 230, 234 (discussing waivers of § 506(c) claims).

In our view, this proposal is misguided and would on balance be more harmful than helpful. It is grounded in a perception that secured creditors are overreaching and that debtors cannot be expected to negotiate good deals for the estate. But the Report fails to present any reliable evidence that this perceived dynamic is, in fact, a reality, or that debtors' agreement to such waivers is undermining the effectiveness of chapter 11. And in the absence of such evidence, a categorical ban restricting the debtor's free choice is likely to lead to worse bankruptcy outcomes.

All else being equal, the debtor is more likely to maximize value for the estate if the debtor has more options, not fewer. Waivers are often given in exchange for other benefits that the debtor judges to be of greater value to the estate. By giving secured creditors the assurance that their right to receive the proceeds of their collateral will not later be subject to challenge, waivers can help debtors reach beneficial agreements with their secured creditors, such as the secured creditor's consent to the use or priming of its collateral, its provision of new financing to support the reorganization effort, or its agreement to fund various administrative expenses through carve-out agreements. Debtors may value those benefits more highly than the statutory right to invoke the "equities of the case" exception (or § 506(c) surcharge) in cases where there are few or no unencumbered assets.

The Report offers no substantial reason to believe that debtors are any less capable of weighing the relative costs and benefits of agreeing to such waivers in connection with such agreements than they are with respect to any other business decision they make in chapter 11. And in those instances where a debtor does seek to enter into an improvident waiver that threatens to harm the interests of the estate, creditors can object, and the bankruptcy court can decline to approve the waiver if it determines, based on the particular circumstances, that the waiver is not in the best interests of creditors and the estate.[325] But the Report provides no compelling reason why that choice should be removed altogether from the parties whose economic interests are directly at stake and whom the Bankruptcy Code normally presumes are best suited to make those judgments.

C. Surcharge of Collateral (Section 506)

The Report proposes that a similar ban on waivers should be adopted with respect to the trustee's right to surcharge collateral under § 506(c) of the Bankruptcy Code. Section 506(c) provides that "[t]he trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim."[326] The Report notes that, as with waivers of the "equities of the case" exception, debtors often waive the right to surcharge collateral under § 506(c) in exchange for carve-outs or other benefits in connection with DIP financing or cash collateral agreements.[327] Expressing doubts about the debtor's ability to negotiate beneficial agreements, however, the Report proposes that "[t]he trustee should not be permitted to waive its ability to surcharge collateral, or to agree not to pursue such a surcharge" under § 506(c).[328] For the reasons discussed above in connection with the Report's recommendation to ban waivers of the "equities of the case" exception, we believe that this proposal is flawed and should not be adopted.

D. Section 363 Sales

Section 363 sales of substantially all of a debtor's assets have become a flashpoint for debate over the last fifteen years. As discussed above, some commentators and practitioners have expressed concern that senior secured creditors are increasingly making use of § 363 sales in order to cash out quickly in situations in which a reorganization—or perhaps a sale conducted on a slower timetable—would yield more value for the estate as a whole.[329] The Commission has proposed two significant changes to § 363 as it currently operates—a presumptive 60-day moratorium on § 363 sales of substantially all the debtor's assets and the addition to § 363 of some, but

[325] Indeed, local rules in many jurisdictions require debtors to highlight any waiver of the "equities of the case" exception (or § 506(c) surcharge) in any motion to approve DIP financing or cash collateral, in order to ensure that such waivers receive appropriate consideration by the debtor's other stakeholders and the court. *See* Bankr. D. Del. Local Rule § 4001-2(a)(i)(C), (H); Bankr. S.D.N.Y. Local Rule § 4001-2(a)(8); Bankr. N.D. Ill. Local Rule § 4001-2(A)(2)(c); Bankr. C.D. Cal. Local Rule § 4001-2(b)(3).

[326] 11 U.S.C. § 506(c).

[327] Report at 228, 230.

[328] *Id.* at 226, 230.

[329] *See, e.g.*, Jacoby & Janger, *supra* note 88, at 866-70; Klee & Levin, *supra* note 63, at 473; Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test With Bite*, 159 U. Pa. L. Rev. 1189, 1214 (2011); Elizabeth B. Rose, *Chocolate, Flowers and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 Emory Bankr. Dev. J. 249, 272 (2006); Report at 83-87.

not all, of § 1129's requirements for plans. The proposed moratorium, however, is not based on reliable empirical evidence that demonstrates § 363 sales undervalue enterprises. And to the extent the Commission's proposals are grounded in legitimate concerns, those concerns can be accommodated within the confines of existing law, without depriving debtors, creditors, and courts of the necessary flexibility to determine what is in the estate's best interests.

1. Existing Law

Section 363 of the Bankruptcy Code allows a debtor to use or sell property of the estate outside the ordinary course of its business, free and clear of all liens and encumbrances (if specified requirements are met), if the debtor obtains court approval at a hearing upon notice to all parties in interest.[330] Section 363 sales may involve the sale of the business as a going concern or piecemeal liquidation of the assets. The goal of a going-concern sale under § 363, as with a plan of reorganization, "is to achieve the greatest value for a company's creditors and shareholders while preserving going-concern value."[331] A major benefit of § 363 sales is that such sales are consummated more quickly and with fewer costs than traditional reorganizations.

To obtain approval of a § 363 sale, a debtor is required to demonstrate that there is a "good business reason" for the sale.[332] If a court determines that the sale is not in the best interests of the estate, or if the court believes that the proposed sale order improperly distributes assets in contravention of other provisions of the Bankruptcy Code, the court can and should deny approval of the sale.[333]

2. The Commission's Proposal

The Commission's most significant proposal regarding § 363 sales is its proposed moratorium on § 363 sales of substantially all of a debtor's assets for 60 days after the bankruptcy filing. That 60-day period may not be shortened unless "the trustee or a party in interest demonstrates by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during [the] 60-day period."[334] The Report explains that "sales of all or substantially all of a debtor's assets on an expedited basis, particularly early in the chapter 11 case, can raise concerns about (a) the proper valuation and marketing of assets, (b) whether other restructuring alternatives were fully explored, and (c) whether the court, the U.S. Trustee, and stakeholders have sufficient information and time to review and comment on the proposed transaction."[335] The Report observes that "the average time between the petition date and the sale date has steadily decreased,"[336] and notes the "perception" that secured creditors are pushing § 363 sales to occur too quickly,[337] as well as "[a]necdotal evidence" suggesting that secured creditors strategically "chill bidding and depress the value of assets."[338] The Commission concludes that "section [363] sales are proceeding more quickly than is necessary in many chapter 11 cases," potentially "reduc[ing] the value available for stakeholders."[339] It recommends the 60-day moratorium as a solution to this problem.

The Commission also recommends enactment of a new "§ 363x" that would incorporate various requirements to ensure that creditors are afforded "at least the same level of protection in the sale process as they enjoy in the plan confirmation process."[340] Before approving a § 363x sale on a regular or an expedited basis, the court must find by a preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the

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[330] *See* 11 U.S.C. § 363(b), (f).

[331] Wilkerson, *supra* note 90, at 595.

[332] *See, e.g.*, *In re Lionel Corp.*, 722 F.2d 1063, 1072 (2d Cir. 1983).

[333] *See, e.g.*, *In re Sunland, Inc.*, 507 B.R. 753, 759-60, 762 (Bankr. N.M. 2014) (disapproving § 363 sale after receipt of upset bid because proceeding with sale for lower price could not be in best interests of estate); *In re Encore Healthcare Assocs.*, 312 B.R. 52, 56-58 (Bankr. E.D. Pa. 2004) (denying approval for sale procedures where court found no business justification for § 363 sale); *In re Cloverleaf Enters.*, 2010 Bankr. Lexis 1301, at *14 (Bankr. D. Md. Apr. 2, 2010) (denying approval for unmarketed sale benefiting only single creditor).

[334] Report at 83.

[335] *Id.* at 84.

[336] *Id.* at 85 & tbl.

[337] *Id.* at 86-87.

[338] *Id.* at 202.

[339] *Id.* at 87.

[340] *Id.* at 206.

following requirements:

- The sale must comply with all applicable provisions of the Code (comparable plan provision found in § 1129(a)(1));

- The proponent of the sale complies with applicable provisions of the Code (comparable plan provision found in § 1129(a)(2));

- The sale was proposed in good faith and not by any means forbidden by law (comparable plan provision found in § 1129(a)(3));

- All payments made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in connection with the case or in connection with the sale and incident to the case, must be approved by, or are subject to the approval of, the court as reasonable (comparable plan provision found in § 1129(a)(4));

- The sale proceeds must be reserved by the debtor in an amount sufficient to pay all allowed administrative expenses through the sale closing date (comparable plan provision found in § 1129(a)(9)(A));

- All fees payable under section 1930 of title 28 of the U.S. Code, as determined by the court at the hearing on the sale, have been paid or the trustee provides for the payment of all such fees on the date of closing of the sale (comparable plan provision found in § 1129(a)(12)); and

- The Trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection for the purchaser in the order approving the sale.[341]

These requirements closely track several of the requirements for confirming a chapter 11 plan under § 1129(a) of the Bankruptcy Code, although they do not include the plan-confirmation requirements that creditors consent by the requisite vote or that dissenting creditors receive distributions that equal or exceed what they would receive in a chapter 7 liquidation and that comply with the absolute priority rule.[342]

3. Implications Of The Commission's Proposals

a. Moratorium

In brief, the Commission's proposed 60-day moratorium on § 363 sales is based on perception rather than evidence, and we believe it is likely to do more harm than good. To the extent the proposal addresses legitimate concerns, those concerns can be addressed under current law.

Citing research showing only that the average time between the petition date and the date of a § 363 sale order has become shorter since the early 1990s, the Commission posits that sales are occurring too quickly to allow for robust auctions or proper exploration of restructuring alternatives, and that the full value of businesses thus is not being recognized, to the detriment of junior creditors.[343] Based on these "perceptions," the Report concludes "that in many cases the potential harm to the estate from a sale that is pushed through more quickly than necessary under the circumstances significantly outweighs any potential benefits of such sale."[344] But, in fact, there is no reliable empirical evidence demonstrating that § 363 sales fail to generate fair market value or that a moratorium will increase value. To the contrary, recent research suggests that the market for distressed assets is robust, and that bankruptcy sales can and do realize as much value for all stakeholders as a traditional reorganization.[345]

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[341] *Id.* at 201.

[342] *See* 11 U.S.C. § 1129(a)(7)-(8), (10); *id.* § 1129(b).

[343] Report at 85.

[344] *Id.* at 87.

[345] Wilkerson, *supra* note 90, at 625-26.

As discussed above, *supra* Part II.A.2, Professor Westbrook found, contrary to the Commission's view, that § 363 sales have not "dominat[ed] Chapter 11 practice."[346] His study, which involved 424 large and small chapter 11 cases filed in nine bankruptcy districts in 2006, found that fewer than 30% of cases had § 363 sales of any kind, and many of those sales may not have been sales of substantially all the debtor's assets.[347] The Westbrook study concluded that the association between such sales and secured creditor control "is undemonstrated and tenuous."[348] Other studies have also concluded that such sales have not "overtaken reorganization."[349] Wilkerson found that only 21% of cases from 1982 to 2011 involved § 363 sales, and that although there was a spike in sales during the Great Recession, the percentage of cases involving sales returned to "normalcy" by 2010 and 2011.[350] In addition, the LSTA's DIP Study, which involved a sample of 157 public companies with listed aggregate assets of at least $500 million that filed for chapter 11 between 2006 and 2011, found that only 12% of those cases involved § 363 sales of substantially all of the debtors' assets.[351]

Moreover, despite an earlier—and criticized[352]—study by Lynn LoPucki and Joseph Doherty suggesting that § 363 sales led to reduced recoveries, recent scholarship has reached the opposite conclusion. *See supra* Part 11.A.2 The Wilkerson study concluded that secured-creditor control "does not appear to lead to more § 363 sales or lower value."[353] And a study by Gilson, Hotchkiss, and Osborn involving 350 large chapter 11 cases filed between 2002 and 2011 tested the popular narrative that secured creditors' "incentive to force the sale of assets … at the expense of more junior claimants" means that "when senior creditors are more powerful, … more assets will be sold … for less than they would be worth in a stand-alone reorganization."[354] Although the authors noted a positive relationship between higher secured-debt ratios and § 363 sales,[355] they also found that secured-creditor control is positively associated *only* with going-concern sales, not with liquidations.[356] They concluded, "our interpretation is that while secured debt is associated with a higher incidence of sales of all assets, it is not linked to a loss of going concern value."[357]

Indeed, there is reason to believe that in some cases, a moratorium would be affirmatively harmful to the bankruptcy estate. That is so for several reasons. As an initial matter, the Report sets a very high burden of proof for demonstrating the existence of a "melting ice cube" problem—clear and convincing evidence that there is a high likelihood that the company's value would otherwise decrease significantly. Application of that burden of proof—rather than, say, a preponderance of the evidence standard—necessarily errs on the side of letting ice cubes melt. Moreover, in many cases, delaying a sale may not provide the benefits the Commission hopes for. Many debtors, for example, engage in a robust marketing process prior to filing for bankruptcy and would not necessarily realize an increase in value from an extended marketing process in bankruptcy.[358] Moreover, many debtors can ill afford the costs of operating the business during an extended stay in bankruptcy and the potential hangover effect on the business from such an extended stay. Lengthening the time spent in bankruptcy before completing a sale will increase administrative expenses, including both the business's operating costs (and the costs of any related DIP financing) and the costs of the bankruptcy process itself, including the professional fees of the debtor and other parties in interest.

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[346] Westbrook, *supra* note 53, at 843.

[347] *Id.*

[348] *Id.* at 844-45; *but see* Ayotte & Morrison, *supra* note 87, at 514-15 (finding that ratio of secured debt to assets correlated with likelihood of sale).

[349] Wilkerson, *supra* note 90, at 600-01 & tbl.1.

[350] *Id.*

[351] *Supplemental Written Statement of Mark Shapiro, supra* note 7.

[352] LoPucki & Doherty, *supra* note 149; *see, e.g.*, White, *supra* note 150 (critiquing LoPucki & Doherty); Wilkerson, *supra* note 90, at 594-95 (same).

[353] Wilkerson, *supra* note 90, at 625.

[354] Gilson et al. 2015, supra note 51, at 4.

[355] *Id.* at 5.

[356] *Id.* at 24.

[357] *Id.*; see also Jenkins & Smith, supra note 52 (finding that inefficient liquidations occur much less often than believed).

[358] Lawrence V. Gelber & James T. Bentley, *Asset Sales: ABI Commission's Recommendations Could Make Value Realization by Secured Creditors a Waiting Game of Diminishing Returns*, 27 BNA Bankr, L.Reporter 387 (2015).

As with the Report's proposals to ban waivers of the "equities of the case" and collateral-surcharge provisions discussed above, the Commission's proposed solution here, to redress its perception that secured creditors are forcing value-reducing sales, is to restrict the ability of debtors, creditors, and bankruptcy judges to determine for themselves what course of action will best maximize value, in light of the particular facts of the case at hand. And here as well, the Report fails to provide no convincing reason to believe that the stakeholders and judges are systematically incapable of performing that task. As one witness who testified before the Commission explained:

> A consideration/concern that has been raised is whether Section 363 sales happen too quickly or that the process may be short circuited. Should consideration be given to a minimum (i.e. mandatory) evaluation time for assessment of circumstances, except if the proverbial "melting ice cube" effect prevails? As a consultant in the middle to lower middle market for the better part of the last two decades, I can assure you that the melting ice cube situation has historically been and will continue to be the rule more than and rather than the exception. Based on my experience, the quicker a company gets in and gets out of bankruptcy, the better the chance for its long term viability. If a constituency feels there is a need for more assessment time, there is nothing stopping the particular stakeholder from going into court; presenting their case to the Judge and explaining their circumstances. I have never been involved in a case where, if a party presented a compelling reason for more time, the Judge didn't grant the request. So why establish a mandatory time limit that could have far reaching negative implications and could likely force a potentially viable business into a further distressed alternative?[359]

Indeed, a former U.S. Chief Bankruptcy Judge for the Eastern District of New York also cautioned that "imposing deadline or time frames (such as a mandatory time line between the filing of the motion and the sale) may not be in the interests of the middle market debtor."[360]

To be sure, there may be instances in which a secured creditor or other party in interest seeks to force a quick sale to further its own interests rather than those of the estate. But under existing law, if a stakeholder can demonstrate that the debtor's proposed sale is ill-advised or contrary to the best interests of the estate, bankruptcy courts can and do decline to approve such a sale.[361] Given the lack of any hard evidence that a moratorium will increase value for the estate, and the certainty that it will increase costs, the Commission's proposal sweeps too broadly, and we believe it should not be adopted.

b. Other § 363x Proposals

The Commission also proposes a number of new requirements for a § 363 sale that mirror some of the requirements for confirmation of a chapter 11 plan. In general, these proposals are innocuous, but likely unnecessary. For instance, the requirement that the sale and its proponent comply with the applicable provisions of the Bankruptcy Code and the requirement that the sale be in good faith should already be implicit in the Code as it stands. The requirement for adequate notice and an opportunity to be heard is already explicitly set out in § 363.[362]

The only new requirement of substantive importance is the Commission's proposed requirement that the trustee withhold sufficient proceeds from the sale to pay all administrative claims in full.[363] This proposed requirement has a reasonable foundation. There has been increased concern regarding "structured dismissals" following § 363 sales that leave debtors' estates administratively insolvent.[364] It is only fair that the beneficiary of a sale bear

[359] Robert D. Katz, *Testimony Before the ABI Commission to Study the Reform of Chapter 11* (Nov. 15, 2012), available at http://commission.abi.org/sites/default/files/statements/15nov2012/Robert_Katz.docx.

[360] Hon. Melanie L. Cyganowski (Ret.), *Testimony Before the ABI Commission to Study the Reform of Chapter 11* (Nov. 15, 2012), available at http://commission.abi.org/sites/default/files/statements/15nov2012/Melanie_Cyganowski.doc.

[361] *See* cases cited *supra* note 333.

[362] 11 U.S.C. § 363(b)(1).

[363] Report at 201.

[364] Nan Roberts Eitel et al., *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, Am. Bankr. Inst. J., March 2011, at 20; *In re Biolitec, Inc.*, 528 B.R. 261 (Bankr. D.N.J. 2014) ("Even if a structured dismissal would result in more assets being made available to the creditor body, such relief may not be approved without assurances that creditor protections provided by confirmation or liquidation pursuant to §1129 or dismissal or conversion pursuant to §1112(b) are either present or waived by all parties."); *In re Strategic Labor, Inc.*, 467 B.R. 11, 17 n.10 (Bankr. D. Mass. 2012).

the legitimate and reasonable costs associated with the sale. However, as explained below, that result should already obtain under current law. And because the Commission's proposal would essentially give the estate a blank check, rather than requiring it to negotiate with the secured creditor over a budget for the costs the creditor will bear, it would certainly increase those costs.

If a sale of a secured creditor's collateral may render a bankruptcy estate administratively insolvent, the court should either not approve it, or take steps to mitigate the risk.[365] For that reason, when a secured creditor is advocating such a sale, it must negotiate with the debtor over a carve-out from its collateral to pay the necessary and reasonable costs of the bankruptcy case, including the administrative expenses necessary to operate the business in chapter 11 pending completion of the sale. Typically, the creditor and debtor will agree on a budget, often in connection with negotiating DIP financing to provide the necessary liquidity to continue the debtor's operations during the bankruptcy process. If the secured creditor and debtor cannot reach an agreement to fund the bankruptcy case, the court will not approve the sale, and the secured creditor will be left to pursue its state-law remedies. In short, if a secured creditor wants the benefit of a sale in bankruptcy, it must pay the reasonable costs of the bankruptcy process.[366] But the secured creditor can decide for itself, in advance, if the benefit outweighs the cost.

The Commission's proposal, however, would take the secured creditor's choice away. Rather than requiring the parties to agree in advance on the cost the secured creditor will pay, the Commission's proposal would give the debtor the ability simply to conduct the sale and deduct all allowed administrative expenses from the proceeds—without regard to whether the administrative expenses were necessary to maintain or dispose of the collateral (consider, for example, the professional fees incurred by a creditors' committee that has undertaken a massive litigation campaign in order to extract hold-up value), and regardless of the terms of an agreed DIP financing budget.[367] To be sure, a secured creditor could object to the allowance of an administrative claim on the ground that it was not necessary or reasonable,[368] but that is a fundamentally different (and worse) position for the creditor than negotiating a budget before the services are rendered. In sum, while it is fair to say that secured creditors should not be entitled to foist the administrative costs of a bankruptcy sale conducted for their benefit on other creditors, existing law provides a sensible solution to that problem, and the Commission's proposal would be likely merely to increase costs at the secured creditor's expense.

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The Report's proposed solutions to perceived, but empirically unproven, problems with § 363 sales would lead to increased costs for estates and secured creditors alike. If the Commission's changes are implemented, the only guarantees are that cases would be longer and more expensive and that secured creditors' costs and risk would increase—potentially increasing the cost of credit for the very constituents the Commission seeks to protect.

E. DIP Lending

"Adequate [debtor-in-possession] financing is the lifeblood for most chapter 11 debtors."[369] Because many debtors enter bankruptcy without sufficient liquidity to operate their businesses, they seek postpetition DIP loans to provide immediate cash and ongoing working capital during the reorganization process. DIP financing is thus "critical to normalize postpetition trade credit and, in many instances, is necessary to avoid liquidation of the

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[365] Because the administrative insolvency of a chapter 11 estate is a ground on which a case may be dismissed, *see* 11 U.S.C. §§ 1112(b)(4)(A), 1112(b)(4)(M), 1129(a)(9)(A), courts may decline to approve a sale that will render the estate administratively insolvent.

[366] In addition, § 506 of the Bankruptcy Code provides that the trustee may recover from the sale proceeds of the collateral the reasonable and necessary costs of preserving and disposing of the collateral to the extent of any benefit to the secured creditor, *see* 11 U.S.C. § 506, consistent with similar requirements under non-bankruptcy law, *see, e.g.*, Uniform Commercial Code § 9-615(a). *See also In re Anderson*, 66 B.R. 97, 99 (B.A.P. 9th Cir. 1986).

[367] It is unclear whether the Commission intended to provide that, even when there are unencumbered assets in the estate, all the administrative expenses should be deducted from the secured creditor's collateral. While we assume that the Commission did not so intend, if it did, that would be wrong for another fundamental reason: It would elevate the priority of administrative claimants above that of secured creditors, in contravention of the basic rule of absolute priority.

[368] 11 U.S.C. § 503(b).

[369] Marcia L. Goldstein, Michele J. Meises & Gabriel A. Morgan, *Debtor in Possession Financing and Second Lien/Subordination Issues*, SS029 ALI-ABA 1, 2 (2011).

company."[370] While the Bankruptcy Code offers some protections designed to induce postpetition lenders to extend postpetition credit, such as liens on any unencumbered assets or priming liens where the prepetition secured creditors can be adequately protected,[371] those protections are not always sufficient to induce lenders to lend to already financially distressed entities with few to no unencumbered assets. Accordingly, many debtors offer additional protections in DIP agreements to induce lenders to extend new financing, including "roll-ups" of prepetition debt, liens on avoidance actions, waivers of certain of the debtor's rights against the lender's collateral, and case "milestones."

The Report proposes either to ban or to restrict the use of these provisions. As with many of its other proposals, however, the Report proposes these changes not to address any proven harm, but to redress a perceived increase in lender control and a concern that DIP lenders may "overreach or negatively impact the rights of other stakeholders beyond the terms necessary to obtain postpetition credit in a particular case."[372] The Report fails to provide empirical data showing that DIP loans, or the provisions the Report seeks to restrict, are leading to loss of value. And the Report's proposals are likely to have harmful effects on the cost and availability of postpetition financing for chapter 11 debtors. The provisions the Report seeks to restrict help debtors preserve their going-concern value by offering nonmonetary inducements to lend. They are the very incentives that attract lenders to make new DIP loans or to provide an existing prepetition lender with the protections it needs to make a postpetition loan. Prohibiting such provisions would impede debtors from obtaining DIP financing, to the detriment of all stakeholders.

1. The Commission's Proposals

In a nutshell, the Commission proposes restricting the permissible terms of DIP loans by:

- Banning roll-ups (which operate to convert prepetition secured loans made by a DIP lender into postpetition obligations) unless the lender extends substantial new credit to the debtor and provides more financing on better terms than alternative facilities, and the court finds that the DIP loan is in the best interests of the estate.[373]
- Banning liens on avoidance actions or their proceeds.[374]
- Banning "milestones" (defined as "tasks or conditions that relate in a material or significant way to the debtor's operations … or to the resolution of the case, including deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and a chapter 11 plan," but not including compliance with ordinary budgets, covenants and payment provisions) that occur within 60 days of the petition date.[375]
- Prohibiting debtors from waiving the "equities of the case" exception of § 552 and the ability to surcharge secured creditor's collateral under § 506(c).[376]
- Banning "extraordinary financing provisions" (including roll-ups, milestones, and representations regarding the validity of a lender's lien) in interim DIP financing orders.[377].
- Making unenforceable prepetition intercreditor agreements barring junior creditors from providing DIP financing, as long as the junior creditors do not obtain a lien senior to the prepetition senior creditors' lien and the senior creditors are allowed to match any terms offered by the junior creditors.[378]

The Commission concluded that these prohibited or restricted terms (also known as "control provisions") were not necessary to induce DIP lenders to lend and that they represented "overreach[ing]" by lenders that nega-

[370] *Id.*

[371] *See* 11 U.S.C. § 364.

[372] Report at 77.

[373] *Id.* at 73.

[374] *Id.*

[375] *Id.* at 79-80.

[376] *Id.* at 80; *see supra* Part III.B.2, III.C.

[377] Report at 80.

[378] *Id.* at 73.

tively affected other stakeholders. For example, milestone provisions arguably permit lenders to force quick sales and otherwise exercise control over the course of the bankruptcy case—leading to a loss of value that might be recognized through a reorganization or a more extended sale process—while roll-ups allow lenders to improve their credit position, potentially to the detriment of other constituencies.[379]

2. Implications of the Commission's Proposals

The Commission's proposals would impose significant substantive restrictions on the terms of loan agreements that are now freely negotiated, in the interest of protecting the debtor and other stakeholders against predatory lenders. Once again, there is little or no evidence that the provisions the Commission is restricting actually cause harm, while there is a significant likelihood that the Commission's recommendations would backfire and harm debtors and stakeholders by making it more difficult and expensive to obtain DIP financing.

As discussed earlier, *see supra* Part II.A.2, the empirical data do not support anecdotal impressions that DIP loans with roll-ups or other control provisions frequently cause value-reducing quick sales or liquidations in chapter 11. The LSTA's DIP Study determined that while nearly all DIP loans included so-called extraordinary provisions, such as milestones or roll-ups, only about 25% of the cases had converted to chapter 7, involved § 363 sales of all of the debtor's assets, and/or involved confirmation of liquidating plans. Even those cases resulting in § 363 sales often involved going-concern sales that maximized the debtor's enterprise value for the estate, rather than piecemeal liquidation. Moreover, the DIP study showed that debtors with DIP financing were more likely to reorganize, and less likely to liquidate, than debtors without DIP financing.[380] In sum, there is little if any hard evidence to suggest that control provisions in DIP loans have the pernicious consequences the Commission fears.

Restricting the terms of DIP loans in the way the Commission proposes, however, will almost certainly increase the cost of DIP financing and make it more difficult for debtors to obtain. That, in turn, could cause many debtors to liquidate unnecessarily, when they could have preserved their businesses as going concerns if financing were available.

Lenders make credit decisions by evaluating the risk of lending to the debtor; higher-risk debtors require facilities with higher interest rates, stricter covenants, and higher collateral requirements.[381] A financially distressed company in bankruptcy presents a significant credit risk. Moreover, a DIP lender must evaluate (and price) on a case-by-case basis the additional risk associated with lending into the bankruptcy process, with its attendant uncertainties. In addition to assessing the feasibility of the debtor's plan, the lender must consider costs associated with potential challenges from other stakeholders or other circumstances causing delays, such as the appointment of an examiner. The control provisions the Commission has targeted are negotiated with the debtor and tailored to the circumstances of the case: They compensate lenders both for the uncertainty associated with the bankruptcy process and for the risk associated with the particular debtor's circumstances.

Each such provision thus has "a purpose and underlying value to the lender, and becomes part of the lender's overall risk-benefit analysis concerning the potential DIP loan."[382] If any one provision is prohibited, the lender will either look to other terms to give the DIP loan the same risk profile as loans currently available or compensate for the increased risk by charging higher rates and fees. As one market participant who testified before the Commission observed:

> If the Bankruptcy Code were to be amended to restrict a DIP lender's ability to employ some of the tools now available, the obvious consequence would be that lenders would need to compensate for the loss of those tools by otherwise negotiating terms to obtain the same risk profile, on the one hand, or simply charge more for the increased risk, on the other. If those alternatives were not available, DIP lenders would choose not to make those loans.[383]

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[379] *Id.* at 75-79.

[380] *Supplemental Written Statement of Mark Shapiro, supra* note 7Other studies have come to the same conclusion. *See, e.g.*, Dahiya, *supra* note 156.

[381] *Supplemental Written Statement of Mark Shapiro, supra* note 7.

[382] *Id.*

[383] *Id.*

Companies that require postpetition credit in order to finance their continued operations, and cannot obtain it elsewhere, might be forced to liquidate as a result.[384]

Roll-ups, for example, induce lenders to lend more capital, or lend on more favorable terms, than they would without a roll-up.[385] Roll-ups remove the threat of a nonconsensual cramdown because the Bankruptcy Code requires full repayment of administrative claims upon the effective date of the plan.[386] Roll-ups therefore increase the likelihood of repayment to prepetition lenders who are willing to extend additional credit to the debtor, or who are willing to permit a third party to "prime" their lien (that is, obtain a lien senior to their lien). A loan without a roll-up is less attractive to a potential DIP lender than a loan with one, and if roll-ups are barred, the lender will simply demand other compensation—either a higher interest rate or some other form of credit protection.[387]

The same analysis applies to other control provisions that the Commission would restrict. Provisions requiring a debtor to acknowledge the validity of a DIP lender's prepetition lien, for example, assure the DIP lender that it will not extend additional credit only to have the debtor challenge the validity of its existing claims.[388] Moreover, because many debtors do not have unencumbered assets to offer as collateral to a DIP lender, these covenants substitute for additional collateral insofar as they reduce risk by protecting the prepetition lender's collateral. Likewise, barring debtors from granting liens on avoidance actions or their proceeds narrows the potential sources of collateral that the debtor can offer to reduce its risk profile and the cost of the DIP loan.

The Report's proposal to ban milestones within the first sixty days of the case will have similar effects. Milestones provide assurance to the DIP lender that the bankruptcy process will run efficiently and minimize the administrative costs associated with drawn-out bankruptcies. They are also useful inducements to lend offered by debtors with deteriorating businesses that can fund only a short chapter 11 case. Where asset recoveries (and enterprise value) may shrink the longer the sale or plan process takes, prudent lending practice warrants the inclusion of covenants designed to achieve "a prompt realization of value."[389]

The Report's proposal to restrict control provisions even further in interim financing orders (banning lien or claim acknowledgements, roll-ups, and milestones altogether in such orders) is also likely to be counterproductive. Most DIP facilities are approved on an interim basis within the first few days of a case and finally approved weeks later. At the time of the interim order, secured lenders are expected to provide financing and/or consent to the use of their cash collateral. Without assurance, for example, that the debtor will not use the lender's own cash to litigate over the validity of its prepetition lien, a lender may be less willing to make initial advances. Prohibiting such protection in interim financing orders will increase a debtor's risk profile, causing DIP lenders either to delay draws (restricting the debtor's much-needed liquidity in its early days in bankruptcy) or to turn to other protections to compensate for the uncertainty and litigation risk they may face on their prepetition claims.

Finally, the Report's proposal to render unenforceable intercreditor agreements prohibiting junior creditors from extending DIP financing is problematic on its merits and would represent an unprecedented expansion of the bankruptcy power. On the merits, there is no evidence that such agreements lead to loss of value. And these agreements certainly serve a legitimate purpose—secured creditors can rationally insist, as a condition to permitting the incurrence of additional indebtedness, that the junior creditors not use the priming authority in bankruptcy to gain control over their collateral. And, again, restricting such provisions will cause lenders to require higher interest rates or other conditions. In addition, the proposal undermines the principle that bankruptcy respects nonbankruptcy rights. No other provision in the Bankruptcy Code prohibits the enforcement of an agreement freely entered into between two nondebtor third parties because of its supposed indirect effect on the debtor.

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[384] *Id.*

[385] *Id.*

[386] *See* 11 U.S.C. § 1129(b).

[387] Schulte Roth & Zabel, Client Alert, *ABI Commission Report Recommendations on DIP Financing Would Eliminate Lender Protection* (2015), available at http://www.srz.com/files/News/ c02da020-b803-4704-a727-25c0e16d29ea/Presentation/NewsAttachment/dc355235-fd79-45b9-87a6-32f0aed2944c/123014_ABI_Commission_Report_Recommendations_on_DIP_Financing_Would_ Eliminate_Lender_ Protection.pdf.

[388] *Supplemental Written Statement of Mark Shapiro, supra* note 7 ("[I]f the debtor is going to take the pre-petition lender's money now in the form of a DIP loan, the debtor will not later use that money in litigation against the lender. In view of the tail-risk associated with making a DIP loan, it is wholly appropriate for a DIP lender to place substantial value on these types of provisions, which serve to mitigate that risk.").

[389] *Id.*

In short, rather than promoting a robust DIP market, the Report's proposals would be likely to increase the cost of credit and hamper the borrowers most in need of DIP financing from obtaining it.

F. Redemption Option Value

One of the Commission's more radical proposals is its proposal to require senior secured creditors, in some circumstances, to give value (which the Commission refers to as "redemption option value") to junior creditors even if the senior creditors are not paid in full. As the Commission recognizes, that proposal violates the basic bankruptcy principle of absolute priority, under which senior creditors are paid in full before junior creditors can recover anything. The proposal is also highly impractical: It would require bankruptcy courts to conduct complex and costly valuation proceedings that are unnecessary under current law, and the Commission has not explained how it would operate in anything other than the simplest case. Nor does the proposal solve any problem that the Commission persuasively demonstrates actually exists: While the Commission suggests that secured creditor control results in systemically depressed enterprise valuations in bankruptcy, depriving junior creditors of value that they should receive, there is no reliable evidence to that effect. Under the circumstances, we believe this costly and perhaps insurmountably complicated proposal would make the Bankruptcy Code worse, not better.

1. Existing Law

As discussed above, *see supra* Part II.C.1, absolute priority is a bedrock principle of current bankruptcy law. As applied to secured creditors, the principle of absolute priority is reflected in the cramdown provisions of chapter 11, which require that a secured creditor receive at least the full value of its collateral before a plan can be confirmed over the creditor's objection.[390] Specifically, § 1129(b) of the Bankruptcy Code requires that a plan provide one of three kinds of treatment to a dissenting class of secured creditors. *First*, if the debtor keeps the collateral, the creditor is entitled to keep its lien and receive deferred cash payments totaling the amount of its secured claim, with a present value as of the plan's effective date equal to the value of the creditor's collateral.[391] Because the Bankruptcy Code permits a secured creditor whose collateral is not being sold to have its entire claim treated as secured and give up any deficiency claim, this means that the secured creditor is entitled to keep its lien on its collateral until the entire debt is paid in full.[392] *Second*, the collateral may be sold, in which case the creditor is permitted to credit-bid the full amount of its claim (secured and unsecured) in the sale, and the creditor's lien attaches to the proceeds of the sale.[393] *Third*, if neither the first nor the second clause applies, the creditor must receive "the indubitable equivalent" of its secured claim (typically meaning that the debtor surrenders the collateral to the creditor or gives the creditor a lien on substitute property of at least equal value).[394] Taken together, the cramdown provisions ensure that no other stakeholder can receive any value from the secured creditor's collateral, over the creditor's objection, until the secured creditor is paid in full.

Under current law, a secured creditor's distribution in bankruptcy thus depends on the value of its collateral on the effective date of the plan, or on the date of the sale of the enterprise. Determining the value of the collateral is relatively simple in the case of a sale, since the purchase price, by definition, establishes the value; the only difficulty arises in determining what part of the purchase price is attributable to the creditor's collateral (if the creditor does not have a valid blanket lien on all of the debtor's assets).

The issues are more complicated, however, if the collateral is not sold, but is used by the reorganized debtor as part of the reorganized business. In that case, if the parties contest the valuation, a judge must decide how to value the collateral, often relying on the testimony of competing experts. Because the valuation of the debtor's assets will determine the distributions that various constituencies will receive under a plan—the higher the valuation, the more likely junior classes are to receive a distribution—valuations are often vigorously contested and, in high-stakes cases, very expensive proceedings.

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[390] 11 U.S.C. § 1129(b).

[391] *Id.* § 1129(b)(2)(A)(i).

[392] *See id.* § 1111(b).

[393] *Id.* § 1129(b)(2)(A)(ii).; *RadLAX*, 132 S.Ct. at 2070. Similarly, if the secured creditor's collateral is sold under § 363 of the Bankruptcy Code, the creditor is entitled to credit-bid its full claim at the sale and to receive all proceeds of the sale of the collateral up to the amount of its claim. *11 U.S.C.* § 363(e), (f), (k).

[394] *Id.* § 1129(b)(2)(A)(iii).

Valuation is an inexact art that involves making judgments in the absence of perfect information. At bottom, valuation is intended to quantify the benefit that will be derived from an asset in the future.[395] A typical method of valuing an enterprise is to look at (1) the present value of the company's projected future cash flows; (2) market valuations of comparable companies; and (3) the implied valuations derived from transactions such as sales of comparable businesses, and to derive a range of values from these indicators.[396] Assessment of value is highly dependent upon the companies and transactions chosen as "comparable" and on the assumptions made about what will happen in the future. Accordingly, valuation is inherently uncertain.

That valuation uncertainty is one of the principal drivers of the negotiation dynamic in chapter 11 cases. Junior creditors will push for higher valuations, which would support a distribution to them; senior creditors will push for lower valuations under which most or all of the firm's value would go to them under the rule of absolute priority. No party, however, knows how the judge will ultimately value the company. Accordingly, senior and junior creditors frequently bargain and come to a consensual resolution under which the senior creditors agree to allocate some value to the junior creditors in recognition of the possibility that the junior creditors' valuation might prevail.[397] The resulting plans may make distributions to junior classes even if senior classes are not being paid in full, but they are not departures from the rule of absolute priority; they are the result of consensual bargaining in the shadow of the rule.[398]

2. The Academic Critique of Absolute Priority and the Concept of "Option Value"

Over the years, various scholars have critiqued the rule of absolute priority as it is currently applied in chapter 11. They have observed that strict application of absolute priority in distributing a firm's assets as they are valued in bankruptcy cuts off the "option value" of junior creditors' claims that would exist under nonbankruptcy law—that is, it prevents out-of-the-money junior creditors from receiving any distribution even if, in the future, the assets appreciate sufficiently to make such a distribution possible. Some have proposed alternative schemes under which junior creditors would receive a distribution on account of the option value of their claims.[399] Because the Commission drew on this literature in formulating its own "redemption option value" proposal, it is helpful to discuss it briefly.

Under current law, plan confirmation operates as a "realization event" upon which the value of a debtor's business is distributed to stakeholders according to their priority. The main insight behind the academic literature on option value is that nothing inherent in the bankruptcy process requires that result. Confirmation need not be a realization event requiring the firm to be divided among the creditors; instead, the parties' relative positions could be preserved.

Outside bankruptcy, if the debtor's business continues in operation and is not sold, senior and junior creditors would maintain their respective claims against the debtor. Even if the firm's current value is less than the amount of the senior creditors' claim, the junior creditors' claim would have some "option value" stemming from the possibility that the firm would generate sufficient value in the future to provide the junior creditors with a payout. Confirmation of a chapter 11 plan, however, effectively cuts off the option value of junior creditors' claims.

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395 See Shannon P. Pratt et al., *Valuing a Business* 56 (5th ed. 2007) ("In the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to the owner of it. The value of the business interest, then, depends upon an estimate of the future benefits[.]").

396 *See, e.g.*, *In re Nellson Neutraceutical, Inc.*, 356 B.R. 364, 370 (Bankr. D. Del. 2006).

397 *See*, *e.g.*, Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1941-44 (2006). Likewise, senior and junior creditors may reach agreements under which junior creditors receive a distribution to resolve claims that certain collateral is outside the scope of the senior creditors' lien. Indeed, the result of such consensual resolutions is that protracted and expensive litigation over valuation is commonly avoided. *See Testimony of Hon. Robert Drain: Las Vegas Field Hearing Before the ABI Comm'n To Study the Reform of Chapter 11* (Feb. 21, 2012), available at http://commission.abi.org/sites/default/files/statements/21feb2013/Rev_ABI_Chapter_11_Commission_Field_Hearing_02212013.doc (noting that contested valuation litigation is relatively uncommon in practice).

398 *See* Baird & Bernstein, *supra* note 397, at 1935 ("'Deviations' from absolute priority often are nothing of the kind. They are instead the natural product of bargaining in a system that is committed to respecting priority, but must do so in a world in which priorities are enforced through a valuation process the outcome of which is uncertain.").

399 *See, e.g.*, Douglas Baird, *Bankruptcy's Lost Paradigm* (forthcoming 2015) (on file with LSTA); Anthony J. Casey, *The Creditor's Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759, 766-68 (2011).

The firm is valued as of the effective date of the plan, and an undersecured creditor with a blanket lien on the firm's assets will (under the default rule of absolute priority) receive all of the firm's value. Junior creditors will receive nothing. Of course, the parties can (and often do) consent to different treatment, but absent consent, the rule of absolute priority means that the senior creditor has the right to all the value derived from the firm's assets until it is paid in full.

Consider, for example, the bankruptcy of an airline whose enterprise value depends on its future profits, which are in turn highly dependent on the future price of oil. Imagine there are three different potential future scenarios: one (with a 30% chance of occurring) in which the value of the airline would be $750 million; one (with a 50% chance of occurring) in which the value would be $1 billion; and one (with a 20% chance of occurring) in which the value would be $1.25 billion. Posit further two classes of creditors—senior creditors who are owed $1 billion, and junior creditors who are owed $500 million.

In this scenario, the junior creditors would have a 20% chance of being paid 50 cents on the dollar. The "option value" of their claims would therefore be ten percent of the face amount of their claims, or $50 million. But if the airline were to be valued in bankruptcy today, its value would be $975 million [($775M x .3) + ($1B x .5) + ($1.25B x .2)], which would be insufficient to cover the senior creditors' $1 billion claim. Accordingly, principles of absolute priority would operate to wipe out the junior creditors' interest, with all of the value going to the senior creditors.

It is important to note that this example is highly stylized. No real firm's value depends on just one variable, and few bankruptcies involve only two classes of creditors. Nonetheless, this example illuminates the way in which absolute priority operates to eliminate option value.

Some scholars have suggested that, in such a scenario, chapter 11 could be modified to preserve the option value of the junior creditors' claims. For example, Anthony Casey has proposed that in this scenario, the junior creditors be given an option to purchase the firm for $1 billion (the value of the senior creditors' claims).[400] Under Casey's proposal, the option could be of indefinite duration, which he views as preferable and which would arguably most closely resemble the scenario outside bankruptcy, or the option could be valued and the value distributed to junior creditors at the time of confirmation.[401] Likewise, Douglas Baird has suggested (without advocating) that, in reorganizations, junior creditors could be given such an option with an arbitrary duration of three or five years.[402]

Both Casey and Baird explore the possibility that such a "relative priority" regime may be more efficient than a strict absolute priority regime, in that it may minimize the costs of the bankruptcy process. Baird suggests that relative priority may eliminate the need for judicial valuations—which are notoriously expensive—in reorganizations. (Baird questions whether relative priority is appropriate for sales, which by definition are realization events requiring distribution of all the firm's value.[403]) If the senior creditors receive all the firm's equity in a reorganization, and the junior creditors receive an option to purchase that equity, "[n]o valuations are necessary…. Whether the firm might or might not be worth enough to pay the senior creditors in full at the time of the petition is not an issue."[404] The junior creditors come out of bankruptcy with an option whose value is the same as the value of the claims with which they went into bankruptcy, and thus neither side has a reason to advocate for a particular valuation.[405]

Casey's proposal is more elaborate and would apply to both sales and reorganizations. Casey views what he calls "option preservation priority" as a way to create incentives for both senior and junior creditors to make decisions that will ultimately maximize the value of the firm.[406] He notes that the current negotiation dynamic has the potential to create two kinds of inefficiencies: Senior creditors who are close to fully secured may attempt to force a quick sale for less than full value because they have little or nothing to gain from any upside; and junior creditors

[400] Casey, *supra* note 399, at 764-765.

[401] *Id.* at 801-05.

[402] Baird, *supra* note 399, at 25-26.

[403] *Id.* at 29.

[404] *Id.* at 23.

[405] *Id.* at 23-24.

[406] Casey, *supra* note 399, at 789-91.

may inefficiently prolong the process and thus dissipate value because they have nothing to lose.[407] To address that problem, Casey proposes a mechanism under which the senior creditor must buy out the junior creditor's option value before it can sell the company.[408] The senior creditor would make a take-it-or-leave-it offer to the junior creditor; if the junior creditor accepted the offer, the sale could go forward, and if the junior creditor rejected the offer, the sale could not go forward. Under these circumstances, Casey argues, the parties will bargain to the most efficient outcome, whether that be a sale or a reorganization, in any particular case.[409] If the outcome is reorganization, the junior creditor retains its option to buy the firm, or that option is cashed out, as described above.[410]

While Casey advocates a relative priority regime, Baird observes that "[w]hether relative priority makes sense turns on whether it avoids the costs of absolute priority without introducing costs of its own."[411] He does not attempt to answer that question. He notes, however, that "[g]iven the cost of judicial valuations, it might seem to make sense to terminate out-of-the-money junior positions when firms are sold, but not when they are reorganized," that "the best attainable reorganization regime may be one that accommodates both sales and reorganizations," and that preserving option value in one regime but not the other could invite strategic behavior.[412] He concludes that "[t]he challenge that we face is finding a priority rule that makes sense given that solving the firm's problem of financial distress may take divergent paths."[413]

3. The Commission's Proposal

The Commission has drawn, to some extent, on the scholarship described above in its "redemption option value" proposal. The Commission's version of relative priority would require undersecured senior creditors in large bankruptcies (not cases involving SMEs) to pay junior creditors the "option value" of their claims either when a chapter 11 plan is confirmed or when the debtor's assets are sold.[414]

Specifically, the Report proposes that the junior class should be entitled to "redemption option value," defined as the value of a hypothetical option to purchase the firm, with a strike price of the full amount of the senior class's claims plus interest and allowable fees and expenses, and a redemption period of three years from the petition date.[415] The bankruptcy court would determine the redemption option value "based on the evidence presented by the parties" at the confirmation or sale hearing, employing the Black-Scholes option pricing model or some other option pricing model.[416] The Report notes that redemption option value would not exist in every case; where the junior class was deeply underwater, the option might well have no value.[417] It also notes that the redemption option value given to the junior class "need not be, and in most cases likely would not be, in the form of an actual option."[418]

The Report also proposes a "death trap" feature: The junior class will be entitled to receive the redemption option value only if it votes in favor of the plan and accepts the reorganization value ascribed to the debtor under the plan, unless that reorganization value was proposed in bad faith.[419] Similarly, in the case of a sale, the junior class can receive the redemption option value only if it does not object to the sale.[420]

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407 *Id.* at 761.

408 *Id.* at 791.

409 *Id.* at 792.

410 *Id.* at 801-04.

411 Baird, *supra* note 399, at 25.

412 *Id.* at 29.

413 *Id.* at 30.

414 Report at 207-11.

415 *Id.*

416 *Id.* at 210.

417 *Id.* at 208, 222-23.

418 *Id.* at 210. The Report proposes that "[t]he form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value," even if the senior class has not accepted the plan. *Id.*

419 *Id.* at 211.

420 *Id.*

The Report notes that the proposal "requires further development to determine whether and how it should be applied in more complex contexts," such as where a senior class of creditors does not have a lien on all the firm's assets, where the junior class was created by contractual or structural subordination rather than a lien, and in a number of other situations.[421]

Unlike Casey and Baird, the Commission does not attempt to justify its proposal on efficiency grounds. Rather, the Report argues that enterprise valuations in bankruptcy are too low, positing that the valuation "may occur during a trough in the debtor's business cycle or the economy as a whole."[422] The Report opines that "relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with … providing a breathing spell from business adversity."[423]

The Commission argues that absolute priority "has proven to be inflexible and often a barrier to a debtor's successful reorganization."[424] "[U]nder the absolute priority rule, junior creditors and interest-holders may lose their rights against the estate and receive no value on account of their claims simply because of the timing of the valuation of the enterprise in the chapter 11 case, while secured creditors, whose rights outside of bankruptcy would have been limited to foreclosure, get the benefits of the chapter 11 case and the exclusive right to the future possibilities of the firm as a reorganized going concern."[425] Although the Commission recognizes that when a firm is sold, the secured creditor does not obtain the "right to the future possibilities of the firm as a reorganized going concern" (unless the secured creditor is itself the buyer), it nonetheless expresses the concern that sale prices could be depressed.[426] "Although the price being offered for a debtor's assets in a section 363 sale arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale … the debtor's estate could be monetized at a value far below what the estate could be worth at a later date to the prejudice of [junior] stakeholders."[427]

The Report also notes that "several witnesses" testified before the Commission that "chapter 11 cases were being run for the benefit of the secured creditors and generating little, if any, value for other creditors," and that "[t]he Commission also heard testimony concerning how … capital structures overwhelmed by secured debt … are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales."[428] Although the Commission did not cite any empirical evidence to that effect, it did note that, between 1989 and 2013, the average duration of a large bankruptcy case in which a plan was confirmed declined from nearly 1,000 days to a little more than 100 days.[429] And it suggested that the shorter duration of cases is leading to depressed enterprise values, justifying the "redemption option value" scheme as a way to ensure that junior stakeholders are receiving a "subjectively fair" distribution.

4. Implications of the Commission's Proposal

The Commission correctly observes that, as discussed above, treating plan confirmation as a realization event forecloses junior creditors' ability to realize the option value of their claims, and that plan confirmation theoretically need not be a realization event. We believe, however, that the Commission's redemption option value proposal, is misguided. *First*, the proposal lacks a coherent analytic justification, because it goes beyond preserving option value that would otherwise be cut off. It can thus be defended only on the unpersuasive ground that it achieves greater "balance" and "subjective fairness." *Second*, the proposal is based on the assumption that companies in bankruptcy are systematically undervalued, but there is no reliable evidence that is the case. *Finally*, even in its most straightforward application, the Commission's proposal will introduce substantial and unnecessary complexity and cost into the bankruptcy process. And it is unclear how the proposal would work in anything but the simplest possible case.

421 *Id.*

422 *Id.* at 207.

423 *Id.*

424 *Id.* at 213.

425 *Id.* at 213-14.

426 *Id.* at 214.

427 *Id.*

428 *Id.* at 215-16.

429 *Id.* at 220-21 & n.794.

a. Conceptual Flaws

The Commission's proposal begins with the recognition that plan confirmation need not be a realization event. As the Commission notes, the timing of the valuation of the enterprise in the chapter 11 case, which determines allocation of value among constituencies, could be viewed as arbitrary.[430] When a senior secured creditor is receiving ownership of the entire firm through a reorganization, junior creditors' claims are cut off even if the firm would later generate sufficient value to pay them. As discussed above, thoughtful scholars have explored the idea that, in that situation, it might be more efficient to preserve the junior creditors' option value in some fashion.

The Commission's proposal, however, extends beyond the scenario in which the concern about cutting off junior creditors' claims exists. The breadth of the proposal is demonstrated by the Commission's decision to apply the redemption option value notion to sales as well as reorganizations. The basic concept underlying option value, however—the idea that a reorganization need not be a realization event—does not apply to sales. A sale, by definition, is a realization event; it converts the firm into cash, which must then be divided among constituencies. As Baird has observed, in that situation it is difficult to see why it would make sense to apply relative priority.[431] After all, if the firm were sold outside bankruptcy, the senior creditor would receive the entire proceeds. A different outcome in bankruptcy creates unnecessary and problematic incentives to force firms into—or keep them out of—bankruptcy for reasons that have nothing to do with bankruptcy's purpose.

The Report acknowledges that applying the redemption option value rule to sales could be viewed as conceptually incoherent. It explains that "[t]he Commissioners discussed the potential challenges to applying the redemption option value rule in a section 363x sale process, particularly where the purchaser is a third party and not the senior class."[432] In those cases, some of the Commissioners argued that requiring the senior creditors to relinquish value to junior creditors was inappropriate when "the senior class was not getting the future value of the firm."[433] The Commission as a whole, however, brushed those concerns aside, concluding that excluding sales from the redemption option value proposal "could encourage gamesmanship and alternative deal structures that avoid the rule but effectively transfer the assets or their future value to the senior class."[434]

But that is an inadequate justification for casting aside creditors' nonbankruptcy rights. Whatever the rule, there is some risk that parties will seek to structure their transactions to avoid its effect. That is a common problem in bankruptcy, and the kind of problem to which the doctrine of good faith and principles of recharacterization are intended to respond. But the need to police the boundaries of a rule to ensure that its principle is not being evaded is not a sound reason to embrace a legislative solution that is substantially broader than the supposed problem to which it is responding. Moreover, as noted above, different distributional outcomes in and out of bankruptcy also invite undesirable strategic behavior.

While Casey also advocates applying an option-value scheme to sales, his purpose in doing so is different; it is not to redress accidents of timing in the interest of "fairness," but to police all creditors' inefficient behavior, including senior creditors' incentive to force value-reducing sales and junior creditors' incentive to prolong proceedings wastefully. He would thus require the creditors themselves to value the option *before* any sale could take place. As discussed below, we believe the benefits of Casey's proposal are outweighed by its costs, but it is conceptually coherent in a way that the Commission's proposal is not.

Ultimately, the Commission's proposal is not concerned with efficiency, but appears to be grounded in its view (reflected in the Commission's mission statement) that secured creditors have too much control over bankruptcy cases, that the "fulcrum security . . . [is now] higher in the debtor's capital structure than [it was] in the past," and that this phenomenon is leading to an "allocation of value" that is "subjectively unfair" even if it flows from the parties' respective "state law rights."[435] In short, the Commission's proposal seemingly stems from, and seeks

[430] Report at 213; *see id.* at 220 (explaining that "the problem at hand" is that "timing can cause the value realization event to allocate value among creditors at a historically low valuation").

[431] Baird, *supra* note 399, at 29.

[432] Report at 223-24.

[433] *Id.* at 224.

[434] *Id.*

[435] *Id.* at 207, 215-17.

to implement, the basic judgment that federal bankruptcy law should seek, as an affirmative policy objective, to distribute value further down the debtor's capital structure than the parties' nonbankruptcy rights would otherwise provide.

In addition to its choice to apply the redemption option value proposal to sales, the Commission's suggestion that it is uncertain whether the proposal should apply in cases "where contractual or structural subordination (rather than a lien) results in an immediately junior class"[436] demonstrates that point. The problem the Commission identifies is that treating bankruptcy as a realization event cuts off junior creditors' "option value." But if that is so, there is no conceptual reason to treat a contractually or structurally subordinated class differently from a class that is junior due to the grant of a security interest. The Commission's solicitude for structural or contractual senior creditors suggests that its proposal is driven in significant part by a simple aversion to secured credit.

The Commission's concern with fairness to junior creditors is also somewhat odd in light of the realities of modern corporate finance. In today's chapter 11 cases, "[t]he contest is most often among seasoned investors (banks, hedge funds, and other institutional investors) who hold debt at different levels of the debtor's capital structure."[437] Particularly in light of the evolution of a sophisticated market in high-yield bonds, the junior creditors the Commission seeks to protect "are sophisticated financial institutions or investment funds that *choose* to invest in a particular part of the debtor's capital structure fully aware of the risk (lower recovery) and rewards (increased interest rate) associated with such choice."[438] Thus, "[t]his proposal could reward those creditors that chose to receive higher interest payments and agreed to take on additional risk while hurting those creditors that chose to receive lower interest rates and invest in a safer portion of the capital structure."[439] Establishing a complex new procedure simply to move value from secured lenders to unsecured bondholders—when both are large institutional investors that chose the risk profile of the debt in which they invested—makes little sense.

b. Empirical Basis

An important premise of the Commission's recommendation appears to be that secured creditors use their control over the bankruptcy case to depress enterprise values artificially—for instance, by engineering a quick sale—so that they can improperly secure value for themselves that would otherwise go to junior constituencies. A critical assumption underlying the recommendation, then, is that enterprise valuations in bankruptcy, whether through a sale or a plan, are systematically too low.

As described above, however, there is no reliable empirical evidence to support that premise, and the empirical evidence that does exist suggests a contrary conclusion.[440] For example, Professors Hotchkiss and Gilson specifically examined whether "secured creditor control" led to sales at depressed levels that would injure other creditors. Their conclusion: "[T]he analysis of recovery rates does not suggest that recoveries either as a whole or to unsecured creditors are lower in cases where senior debtholders potentially have greater control."[441]

The Commission alternatively suggests that in cases in which the debtor is reorganizing, a valuation conducted in bankruptcy is likely to undervalue the debtor's enterprise because the valuation is being conducted during a low ebb in the debtor's business cycle. "Although the valuation at any point in time will necessarily reflect the debtor's future potential, the valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders."[442]

But there is neither evidence showing, nor any principled reason to believe, that valuations conducted of

[436] *Id.* at 211.

[437] Baird & Bernstein, *supra* note 397, at 1933.

[438] Chapman & Cutler LLP, Client Alert, *Redemption Option Value: Broad Implications for Secured Lenders* (2015), available at http://www.chapman.com/media/publication/470_Chapman_ABI_Commission_Chapter_11_Reform_Redemption_Option_Value_Secured_Lenders_010515.pdf.

[439] *Id.*

[440] *See supra* Parts II.A.2, III.D3.

[441] Gilson et al., *supra* note 52, at 29.

[442] Report at 207.

firms in bankruptcy systematically undervalue the firms. By definition, after all, any properly conducted valuation will take into account the likelihood that future changes in economic circumstances will positively affect the debtor's value. To the extent that a particular business is at a low ebb in its cycle, or broader economic conditions ought to increase a debtor's future prospects, those factors should be accounted for in a properly constructed valuation.[443] To the extent the basis for providing junior creditors redemption option value is that the debtor may be in a low ebb in its business cycle at the time the valuation is conducted, it amounts to double counting.

As a result, the Commission's proposal does not solve the problem of "arbitrariness" to which it is addressed. It simply moves the arbitrary time of the realization event from the effective date of the plan or date of the sale to the three-year anniversary of the petition date. Without any evidence that valuations in bankruptcy are systematically depressed—and the Commission points to none—one date is as arbitrary as the other.

c. Practical Consequences

The Commission's proposal also raises a host of practical difficulties. As an initial matter, the need to value the option will add substantial complexity to the bankruptcy process. The Commission suggests that bankruptcy courts should (presumably with the help of expensive expert witnesses with backgrounds in finance, accounting, and economics) determine the option's value by reference to the Black-Scholes model, which requires, among other things, a projection of future volatility in the firm's value—something that is notoriously difficult to assess.[444] To complicate matters further, the Commission acknowledges that there will likely be cases in which the Black-Scholes methodology would not be appropriate, in which case "[t]he Binomial Options Pricing Model, Monte Carlo options models, and other formulas may have to be considered."[445] Such valuation proceedings will not come cheap.

The Commission argues that the "death-trap" feature of its proposal will avoid costly disputes over the valuation of the enterprise by encouraging consensual plans. Under the death-trap feature, the debtor may propose a good-faith estimate of the reorganization value of the enterprise in its plan; the junior class receives the redemption option value only if it does not object to that enterprise value (or, in the case of a sale, if it does not object to the sale).[446] The Commission suggests that the cost of valuing the option might thus be offset by the ability to forgo a more high-stakes valuation of the entire enterprise. There are several problems with that logic, however. As an initial matter, valuing the option necessarily requires at least an implied valuation of the firm, since the option value incorporates the expected volatility in the firm's value. Although the stakes may be lower, the valuation itself will thus be more complex even in cases where the junior creditors decide not to challenge the enterprise valuation. Moreover, in the case of sales, the Commission's proposal adds a judicial valuation where none was previously necessary—one of the major benefits of sales.

Perhaps most importantly, there is no reason to believe that the death-trap feature will in fact result in any more consensual plans than we have today. The idea behind the death-trap is seemingly that it will encourage settlement by giving the junior class more to lose if it elects to litigate. In this respect, the death-trap is like a judge who believes he will encourage the defendant to settle by indicating, at a pretrial conference, his predisposition to rule in favor of the plaintiff. That behavior simply increases the plaintiff's demands, without affecting the likelihood of settlement. In other words, the death-trap may cause the parties to have *different* disputes, but there is no reason to think it will result in *fewer* disputes. In fact, common sense suggests the opposite. The best way to minimize litigation is to have clear and simple rules, so that well-informed parties can make reliable predictions of what will happen in the absence of a settlement. Complex and ambiguous rules, like the redemption option value proposal, multiply rather than reduce litigation.

The proposal becomes even more complex and ambiguous when one considers how it would apply to any case other than the simplest one, in which there is a class of senior creditors with a blanket lien on all the assets, which receives the entire enterprise value of the firm, and an out-of-the-money junior class. The Commission acknowledges that it has not determined how its proposal would work in any case with a more complex capital structure. Indeed, the Commission notes that the proposal

[443] *See generally* Shannon Pratt & Roger Grabowski, *Cost of Capital: Applications and Examples* 6-7, 418-23 (5th ed. 2014).

[444] *See* Stuart C. Gilson et al., *Valuation of Bankrupt Firms*, 13 Rev. Fin. Stud. 43, 44 (2000) (finding that estimates of debtors' values are unbiased, but "not very precise").

[445] Report at 221 n.795.

[446] *Id.* at 209.

> requires further development to determine how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value … , where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all such senior classes are receiving distributions in the form of [equity], where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class but the junior class is not being paid in full.[447]

Examples could obviously be added.

In particular, it is difficult to envision how the Commission's proposal would work in cases in which the debtor is part of a corporate conglomerate with debt issued by many separate entities in the corporate family. Consider a junior creditor that holds a claim against a wholly owned subsidiary, 100 percent of whose shares are held by the parent. An actual option is impracticable: The subsidiary is likely to be fully integrated (as an operational matter) into the corporate family, with its financials consolidated. Having the junior creditor, three years later, acquire the equity of the subsidiary would be unworkable.

To be sure, in the typical case to which the redemption option value proposal is addressed, the senior creditor of the subsidiary would likely receive, under a plan, equity in the corporate parent, not the subsidiary. But giving the junior creditor an option to purchase *that* equity would be essentially random—having little or nothing to do with the likelihood that the assets of the debtor against which the junior creditor had a claim would in the future have a value exceeding the senior creditor's claim. In short, the many practical and logistical difficulties that inhere in the equity redemption option in even the simplest, most stylized situation multiply exponentially in the context of actual, real-world cases.

At the end of the day, what is clear is that the costs of the Commission's proposal outweigh any benefits it might provide. And our view is that the same is true of the Casey proposal, which—while insightful and creative—introduces some of the same complexities and costs, and provides a benefit only to the extent that chapter 11 cases are now resulting in inefficient outcomes. As discussed above, *see supra* Part II.A.2, the most recent studies suggest that while there is almost certainly some inefficiency in the process, some of which may be caused by secured creditor control, there is much less than previously believed. Under those circumstances, there is no clear reason to pursue a complicated new scheme of relative priority.

The current rule of absolute priority, even if not perfect, has the important virtue of simplicity—a virtue that renders it preferable to any of the alternatives. For sales, it is the only rule that respects parties' nonbankruptcy rights. For reorganizations, it is a clear and easily understandable rule against which the parties can bargain. And it lets the reorganized debtor start afresh without the hangover of an outstanding option on its equity or the need to conduct complex option valuation proceedings. Since there must ultimately be a day of reckoning, however long delayed, the simplest and most sensible approach is to have that day be the day the firm is valued or sold in bankruptcy.

G. Voting and Classification

Under the existing Bankruptcy Code, the classification of voters into classes and the vote of creditors are important for two principal reasons. First, the Bankruptcy Code requires that at least one class that is "impaired"—that is, a class that is not being paid in full under the plan—vote in favor of the plan.[448] Second, if a class votes against the plan, the plan can be confirmed only to the extent it satisfies the cramdown requirements—which primarily require that the plan satisfy the absolute priority rule and not unfairly discriminate against the creditors in the class.[449]

The Bankruptcy Code sets out detailed rules governing the classification and voting of claims. The Code provides that claims may be placed in different classes, as long as all claims within a class are "substantially similar

[447] *Id.* at 211.

[448] 11 U.S.C. § 1129(a)(10).

[449] *Id.* § 1129(b).

to the other claims" in that class.[450] And it requires a plan to provide the same treatment for each claim within a class, unless the holder of a particular claim consents to different treatment.[451] Stakeholders vote as a class, rather than individually, on whether to accept the plan. A class is deemed to have voted to accept a plan if at least two-thirds in amount, and at least one-half in number, of the claims in the class that vote do so in favor of the plan.[452] A class that is "unimpaired"—that is, being paid in full under the plan—is deemed to have accepted the plan and therefore does not vote.[453] A class that receives no distribution under a plan is deemed to have rejected the plan and also does not vote.[454] The Code provides that votes can be "designated"—*i.e.*, disregarded—if a court determines that the "acceptance or rejection of [the] plan was not in good faith, or was not solicited or procured in good faith."[455]

A chapter 11 plan can be confirmed only if each impaired class of claims votes in favor of the plan, unless the plan satisfies the cramdown requirements with respect to that class.[456] That is, the plan must "not discriminate unfairly" and must be "fair and equitable" with respect to each nonconsenting impaired class.[457] The requirement that a plan be "fair and equitable" incorporates the absolute priority rule, meaning that a class of claims must be paid in full before any junior class receives any property on account of its claims under the plan.[458] In addition, under current law, a plan can be confirmed only if at least one impaired class votes in favor of the plan.[459] The favorable vote of an impaired class can be viewed as serving as a proxy for the fairness of the plan to creditors as a whole.[460]

The classification and voting rules have given rise to extensive litigation, including disputes about whether classes are improperly gerrymandered to create an accepting impaired class,[461] whether "artificial" impairment of a class—that is, impairment that is not material—suffices for purposes of the rule requiring at least one accepting impaired class,[462] and what grounds suffice for designation of votes as being "not in good faith."[463]

In part to address some of these issues, the Commission proposes a number of changes to the rules regarding classification and voting. *First*, it proposes to eliminate the requirement of an impaired consenting class, the Code's proxy for determining the general acceptability of a plan to all creditors and interest-holders.[464] *Second*, it proposes to alter the thresholds used for counting votes, adopting a new "one creditor, one vote" system consolidating votes of creditors who hold multiple claims in a class.[465] *Third*, it proposes new rules restricting assignment or waiver of voting rights, so that creditors who gave up those rights in an intercreditor agreement prior to bankruptcy, for example, should nonetheless be entitled to exercise them.[466] And *fourth*, it proposes a new statutory standard for vote designation under which a court would be permitted to designate a party's vote if "such party voted in a manner manifestly adverse to the economic interests of the other creditors in the class or did not act in good faith."[467]

If there is a common thread running through these proposals, it is a fear that the various rights, checks, and balances the Code builds into the voting process, rather than fostering consensus, in fact serve to permit, or even facilitate, "gamesmanship" or other self-serving and counterproductive behavior by debtors, creditors, or other

[450] *Id.* § 1122(a).

[451] *Id.* § 1123(a)(4).

[452] *Id.* § 1126(c).

[453] *Id.* § 1126(f).

[454] *Id.* § 1126(g).

[455] *Id.* § 1126(e).

[456] *Id.* §§ 1129(a)(8), 1129(b).

[457] *Id.* § 1129(b).

[458] *Id.* § 1129(b)(2).

[459] *Id.* § 1129(a)(10).

[460] *See, e.g.*, *In re Windsor on the River Assocs., Ltd.*, 7 F.3d 127, 131 (8th Cir. 1993).

[461] *See, e.g.*, *In re Boston Post Road Ltd. P'ship*, 21 F.3d 477, 481-83 (2d Cir. 1994).

[462] *See, e.g.*, *In re Vill. at Camp Bowie I, L.P.*, 710 F.3d 239, 244-48 (5th Cir. 2013).

[463] *See, e.g.*, *In re DBSD N. America*, 634 F.3d 79, 101-05 (2d Cir. 2011).

[464] Report at 257.

[465] *Id*.

[466] *Id.* at 261.

[467] *Id.* at 264.

interest-holders.[468] There is undoubtedly some merit to this concern. There is certainly a fair debate to be had, for example, on the question whether the benefit of requiring an impaired consenting class is worth the associated difficulty of policing strategic behavior on both sides—gerrymandering, artificial impairment, and vote-buying on the side of the plan proponent, and the acquisition and voting of claims for reasons unrelated to the economic recovery on those claims on the other side.

Ultimately, however, we believe that the Commission's proposals are not an improvement over current law. The requirement of an impaired accepting class does serve some useful role (even if an imperfect one) in ensuring the fairness of the plan. The switch to a "one creditor, one vote" standard would introduce additional complexity and line-drawing into a system that works well enough as it is. We do not believe it is appropriate to prevent creditors from voluntarily entering into agreements to assign or waive their votes. And, the existing rules permitting the designation of votes when they are not cast in good faith serve as a sufficient check on the most egregious strategic behavior. Moreover, a class's decision to reject a plan merely requires the debtor to meet the cramdown requirements of respecting absolute priority and not unfairly discriminating against that class. Given that, as explained below, we see little benefit—but a significant potential for mischief—in making it substantially easier to disregard creditors' votes.

1. The Impaired Consenting Class Requirement

The Report recommends the deletion of § 1129(a)(10), which currently requires at least one impaired class to accept a plan before it can be confirmed.[469] To justify this proposal, the Report paints a picture of gamesmanship between debtors and creditors—debtors gerrymandering classes to drown out dissenting creditors while creditors disrupt confirmation by asserting frivolous classification issues.[470] The Report also envisions obstinate creditors who purchase claims in several classes to ensure that there is no impaired consenting class.[471] It then concludes that the cost of such gamesmanship outweighs the benefit of the "presumptive gating role" of the impaired consenting class requirement.[472]

As the legislative history makes clear, the purpose of § 1129(a)(10) "is to provide some indicia of support by affected creditors and prevent confirmation where such support is lacking."[473] The theory is that the acceptance of a plan by at least one class of creditors that is not being paid in full serves as some proxy for the fairness of the plan as a whole.

A reasonable case can be made that the requirement of an impaired consenting class is of only limited utility as a proxy for the fair treatment of other creditors. Creditors may vote to accept or reject a plan for many reasons unrelated to the treatment of the specific claim being voted. Trade creditors, for example, might vote in favor of a plan in the hope of obtaining business from the reorganized debtor. Or a secured creditor may vote its deficiency claim in the service of its recovery on its secured claim. None of that is necessarily improper, but it does weaken the presumption that the acceptance of an impaired consenting class means the plan is fair to other creditors. Nevertheless, an impaired consenting class is an indication that the debtor has engaged in negotiations with its stakeholders and reached a plan that is at least in part consensual. If a debtor cannot obtain the consent of any impaired class, one is justified in being skeptical of the merits of its plan.

To the extent the Commission's concern is that creditors will buy up claims for the sole purpose of blocking plans that are otherwise fair to all, in order to advance some illegitimate purpose, the existing vote designation rule permits a court to designate those votes.[474] The possibility of attempts to misuse a Bankruptcy Code provision

[468] *See, e.g., id.* at 259 ("[C]laims classification and voting under sections 1122 and 1126 are subject to significant gamesmanship."); *id.* at 261 (concluding that "the potential delay, cost, gamesmanship, and value destruction attendant to section 1129(a)(10) in all cases significantly outweighed its presumptive gating role"); *id.* at 263 (expressing concern that "senior creditors influence the plan structure or control the vote on the plan through the assignment provision" in an intercreditor agreement); *id.* at 265 (explaining the Commission's desire to address "self-interested conduct by a creditor holding interests adverse to the debtor or other creditors").

[469] Report at 257.

[470] *Id.*

[471] *Id*. at 260.

[472] *Id.* at 261.

[473] *In re Lettick Typografic, Inc.*, 103 B.R. 32, 38 (Bankr. D. Conn. 1989).

[474] *See, e.g., In re DBSD N. America, Inc.*, 634 F.3d 79, 102 (2d Cir. 2011).

strategically is a ground for enforcing the requirement of good faith, not throwing out the provision.

To be sure, plan proponents can seek to circumvent the purpose of § 1129(a)(10) by fulfilling the requirement's letter but not its spirit. Debtors might gerrymander classes to ensure that dissenting creditors are in the minority or artificially impair a class—delaying the class's recovery for a short period of time, for example—so that the class is in all material respects unimpaired, yet technically can be deemed to satisfy the requirement. But while it is true that debtors can weaken § 1129(a)(10)'s gatekeeping role with gamesmanship, the solution is to stop the gamesmanship, not eliminate § 1129(a)(10). As the Report notes,[475] courts in the Fifth and Ninth Circuits have held that artificial impairment is sufficient to satisfy the requirement of an impaired consenting class, since § 1129(a)(10) has no express motive or materiality requirement.[476] But the Eighth Circuit has rejected the proposition that "impairment may be manufactured at the will of the debtor 'just to stave off the evil day of liquidation.'"[477] It reasoned that "[t]o allow manipulation of claims in a reorganization proceeding under Chapter 11 would be contrary to the purpose of the provisions of the [B]ankruptcy [C]ode."[478] Accordingly, the court refused to honor an attempt at artificial impairment of a class.[479]

The Eighth Circuit's view is more persuasive. Notwithstanding § 1129(a)(10)'s limitations, it is a useful check to require a debtor to negotiate with, and obtain the acceptance of, at least one legitimately drawn class of creditors that will not be paid in full. For § 1129(a)(10) to serve that role, classes cannot be improperly gerrymandered and the impairment of the class must be real—not a trivial impairment manufactured to meet the technical requirement of the rule. When that standard is met, § 1129(a)(10) does serve a useful role, and it should be maintained.

2. One Creditor, One Vote

The Commission proposes a new "one creditor, one vote" rule restricting creditors who hold multiple claims from voting each of their claims at plan confirmation.[480] Under current law, as noted above, a class of claims is considered to vote in favor of a plan when two-thirds in amount of the allowed claims in that class that are voted, and one-half in number of the allowed claims in that class that are voted, vote to accept the plan.[481] A creditor who possesses multiple claims within a class, at least where those claims are sufficiently separate to be treated as distinct, may vote each of those claims separately.[482] The term "claim" is defined in the Bankruptcy Code to mean a "right to payment."[483] As a general matter, a "claim" that arises out of a single transaction or occurrence (within the meaning of the *res judicata* test) is a single "claim."[484] But if a creditor engaged in separate unrelated transactions with a debtor (each of which potentially could give rise to a separate lawsuit to enforce the debt), the creditor may hold separate "claims."

Under the proposed rule of "one creditor, one vote," a creditor would be barred from voting more than once in a class, even if it has entirely separate and distinct claims.[485] However, the Commission proposes an exception where a creditor holds claims in multiple different capacities—for example, where an indenture trustee

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[475] Report at 260.

[476] *See In re Village at Camp Bowie I, L.P.*, 710 F.3d 239, 244-48 (5th Cir. 2013); *In re L&J Anaheim Assocs.*, 995 F.2d 940, 942-43 (9th Cir. 1993).

[477] *In re Windsor on the River Assocs.*, 7 F.3d 127, 131 (8th Cir. 1993).

[478] *Id.*

[479] *Id.*

[480] Report at 259.

[481] 11 U.S.C. § 1126(c).

[482] *See In re Gilbert*, 104 B.R. 206, 211 (Bankr. W.D. Mo. 1989) ("The formula contained in Section 1126(c) speaks in terms of the *number of claims*, not the number of creditors."); *In re Concord Square Apartments of Wood County, Ltd.*, 174 B.R. 71, 74 (Bankr. S.D. Ohio 1994); Anne Marrs Huber & Thomas H. Young, *The Trading of Bank Debt in and out of Chapter 11*, 15 J. Bankr. L. & Prac. 1, Art 3 n.16 (2006).

[483] 11 U.S.C. § 101(5).

[484] *Gilbert*, 104 B.R. at 211 (permitting creditor multiple votes because "each claim arose out of a separate transaction, evidencing separate obligations"); *In re Figter Ltd.*, 118 F.3d 635, 640 (9th Cir. 1997) (same); *In re Jones*, No. 10-53166, 2012 Bankr. Lexis 1076, at *7 (Bankr. M.D. Ga. Mar. 12, 2013) (same); *but see In re Assoc. Vintage Group., Inc.*, 283 B.R. 549, 556 (9th Cir. B.A.P. 2002) ("The term 'claim' as used in 'claim preclusion' analysis differs from the bankruptcy meaning of 'claim.'").

[485] Report at 259.

is also a lender of secured debt.[486] On the other hand, multiple entities with claims under "common investment management," at least in situations where the identity of the voting decision-makers does not differ across entities, would be reduced to a single claim.[487]

The Commission's justification for this proposal is that the numerosity requirement of § 1126(c) is intended to protect the interest of small, minority creditors, but that, in the modern bankruptcy world, it no longer serves that purpose. The Commission argues that small creditors may be too apathetic to vote their claims—although it does not explain how restricting other creditors to one vote would correct this apparent problem.[488] The Commission also argues that the "one creditor, one vote" rule is "less susceptible to abuse" than the traditional rule of § 1126(c).[489] Here, the Commission's concerns appear to focus on perceived "gamesmanship" caused by a single creditor's voting many claims.[490]

While the Commission's concern for protecting the interests of minority creditors is understandable, ultimately it fails to present the evidence necessary to justify this kind of change to the working of the Bankruptcy Code. As described below, the existing vote designation rules are intended to guard against strategic behavior by a creditor for some improper ulterior purpose. The application of that rule provides a simpler solution to the problem the Commission has identified than its alternative, which would involve a potentially complex inquiry into who counts as a single creditor for purposes of the "one creditor, one vote" rule. Although the Commission proposes that the presence or absence of "common investment management" could serve as a test to identify "creditors," even this standard would leave many unresolved issues. Courts would have to decide how much overlap in management and leadership, or in actual investment strategy, ought to be necessary for separate legal entities to be treated as a single creditor. Courts seem likely to face hard—and currently unnecessary—line-drawing problems applying the standard to, for example, multiple subsidiaries or affiliates within a corporate family. In contrast, courts have been distinguishing substantially separate claims from each other for many years under the current § 1126(c) test.[491] In view of the risk that the Commission's proposal would raise questions at least as vexing as the ones faced under current law, we believe the better course would be to leave existing law in place.

3. Assigning and Waiving Plan Voting Rights

The Commission proposes that the assignment or waiver of voting rights in intercreditor or other subordination agreements should be unenforceable in bankruptcy. We believe that there is no reason for such a change, which departs from the basic bankruptcy principle of respecting parties' nonbankruptcy agreements, especially where—as here—both parties are nondebtors who made the agreement voluntarily and at arm's length.

Intercreditor agreements are an everyday feature of modern capital structures, and bankruptcy courts are frequently tasked with enforcing them. Senior creditors often seek to protect their investment in a debtor through subordination or other terms that give them priority in their collateral in case of a default.[492] The Code expressly provides that subordination agreements are enforceable in bankruptcy to the same extent that they would be outside bankruptcy.[493] Such agreements sometimes also provide that the junior creditor waives or assigns its right to vote. Junior creditors agree to such arrangements because they receive consideration—usually, the senior creditor's waiving a covenant restricting the debtor from borrowing—in return.

The Commission recommends making such agreements unenforceable in bankruptcy because it believes that they enable senior creditors to exercise too much influence over the plan and bankruptcy proceedings.[494] Enforcing such clauses, the Commission contends, may worsen outcomes for other creditors.[495] The Commission

[486] *Id.*

[487] *Id.* at 259-60.

[488] *Id.* at 259.

[489] *Id.*

[490] *Id.*

[491] *See Gilbert*, 104 B.R. at 206 (explaining standard in 1989).

[492] Seth Jacobsen et al., *Enforcement of Intercreditor Agreements in Bankruptcy*, 20 Norton J. Bankr. L & Prac. 343, 343 (2011).

[493] 11 U.S.C. § 510.

[494] Report at 262-63.

[495] *Id*. at 263 n. 948 (citing Edward Rust Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 Ill. L. Rev. 721, 726 (2015) ("These

also contends that, since "preserving the agreed-to payment priority was the crucial element of subordination agreements," prohibiting assignment of waiver or voting rights would not disturb the core of such agreements.[496]

There is no basis, however, to treat the waiver or assignment of voting rights as categorically different from any other agreement freely entered into between nondebtor parties. The better view is that such a provision is simply a concession that a junior creditor might grant a senior creditor in an intercreditor agreement, and should be just as enforceable as other provisions in that agreement. It serves to protect the senior secured creditor's interest in its collateral by giving the senior creditor greater control in a subsequent bankruptcy. The junior creditor, of course, received consideration in exchange. And there is nothing facially improper or unreasonable about a senior creditor consenting to the debtor's incurrence of additional debt on the condition that the new junior creditors will not later vote their claims in support of a cramdown plan that injures the senior creditor. For that reason, the Commission's assumption that such terms are not "crucial" to the parties is both factually incorrect and inappropriate. Making a particular provision in an agreement unenforceable alters the entire negotiating dynamic, and it is impossible to say whether the parties would have reached a similar agreement in the provision's absence.

The Code should tread very lightly when contemplating abrogating the right of nondebtors to enter into contractual agreements regarding the bankruptcy of a third party. It is true that certain key protections of bankruptcy law, like the automatic stay and the discharge, are frequently held to be nonwaivable.[497] But the stay and the discharge are core provisions of bankruptcy law aimed at protecting debtors. It is an entirely different matter for the Code to reach out and rearrange privately ordered rights among creditors. The Code shows "no … special solicitude for the protection of creditors, from fellow creditors, pre-petition,"[498] nor should it. That is the realm of state contract law. Moreover, there is no reason to believe that these creditors (typically sophisticated entities with the ability to negotiate for themselves) need the Code's protection from the consequences of the contracts they chose to enter.

The Commission maintains that "[t]he core issue concerns the impact that private ordering among nondebtor parties may have on the debtor, the estate, and other stakeholders in the chapter 11 case."[499] The Commission does not explain what impact it is concerned about, but its implicit point is seemingly that to the extent senior creditors acquire "extra" voting rights, they are exercising improper influence over the outcome of the bankruptcy and can potentially block a reorganization. Again, however, the consequence of a class voting no on a plan (assuming that there is an impaired accepting class) is simply that the plan must satisfy the cramdown requirements for that class. For that reason, the Commission's concern that senior creditors will be able to block plans is overstated. Moreover, once again, the Commission offers no evidence that control by senior creditors leads to worse outcomes for other stakeholders. Before making the radical decision to override a prebankruptcy agreement between two nondebtor third parties that has no direct effect on other stakeholders—who remain free to vote their claims and support or object to the plan—we should require some evidence that such agreements actually cause harm.

4. Vote Designation

Section 1126(e) of the Code currently permits a bankruptcy court to designate—that is, disregard—votes that were not cast, solicited, or procured in "good faith."[500] The Report proposes a new standard for vote designation, under which a judge may designate a party's vote if "such party voted in a manner manifestly adverse to the economic interests of the other creditors in the class," even if the party did not act in bad faith or with an ulterior motive.[501] That standard is far too broad and should not be adopted.

Because it is a "drastic remedy" to prohibit a creditor from participating in plan confirmation, normally an opportunity for "creditor democracy," courts do not lightly designate votes.[502] Historically, courts have designated a

agreements reduce decisionmaking costs in the event of default, but also give senior lenders power to exploit subordinated creditors and potentially other investors in the firm.")).

496 *Id.* at 263.

497 *See, e.g, Rosenfeld*, 2012 U.S. Dist. Lexis 91479, at *15-16.

498 *Id.* at 16.

499 Report at 262.

500 11 U.S.C. § 1126(e).

501 Report at 264-65.

502 *In re Adelphia Comm'ns Corp.*, 359 B.R. 54, 61, 61 n.30 (Bankr. S.D.N.Y. 2006) ("The party seeking to have a ballot disallowed has a

creditor's vote when "the voting process is being used as a device with which to accomplish some ulterior purpose, out of keeping with the purpose of the reorganization process itself, and only incidentally related to the creditor's status *qua* creditor."[503] Where a business competitor buys claims against the debtor in order to force it into liquidation, for example, or where a creditor accepts consideration outside the plan in exchange for its vote, courts do not hesitate to designate the vote on the ground that it was cast in bad faith. On the other hand, in some circumstances, creditors will acquire claims *defensively* rather than *offensively*—to prevent others from interfering with their ability to vote against a plan that disserves their economic interests. The line between merely "selfish behavior"—which is permissible—and bad faith conduct—which is not— is an imprecise one,[504] but courts have proven able to use it to remedy abuses of the voting system.

The Commission's new "manifestly adverse" standard would give bankruptcy judges broard authority to designate votes even where they were cast in good faith and not for an improper purpose, so long as the judge deemed the vote "manifestly adverse" to the economic interests of the other creditors in the class. How a judge would determine what is "manifestly adverse" to the economic interests of an impaired class is unclear. The purpose of voting is to allow creditors to decide for themselves what is in their economic interests, rather than to have a plan imposed on them because the judge believes it is a good one.

Vote designation is an important and necessary bankruptcy tool. It protects the integrity of the plan voting process, and ensures that creditors use that process to further the goals of bankruptcy, and not for some other improper purpose of their own. But the Commission's effort to relax the standard for vote designation would distort the voting process and negotiations among creditors by allowing the bankruptcy court to override a creditor's judgment as to what is in its economic interest. It is also unnecessary. Not only is the good-faith standard up to the task of policing abuse, but the consequence of a class's rejection of a plan (so long as there is some other impaired class that has accepted the plan) is only that the plan must satisfy absolute priority and not discriminate against that class. We see no bankruptcy policy that is served by permitting designation of votes cast in good faith, simply to relieve debtors of the burden of meeting that standard.

H. Small and Medium-Sized Enterprises

The Report proposes an alternative restructuring scheme for small and medium-sized enterprises, or SMEs, that would differ substantially from current chapter 11. The Report defines an SME as a nonpublic company with less than $10 million in assets or liabilities.[505] However, companies with up to $50 million in assets or liabilities could request and obtain SME treatment if the court determines that such treatment is in the best interests of the estate.[506] The Report proposes changes to both chapter 11's procedural and its distributional rules for SMEs.[507]

The Report recommends changing the chapter 11 process for SMEs in several ways. It recommends that a committee of unsecured creditors not be appointed unless the court determines, upon the motion of an unsecured creditor or the U.S. Trustee, that it is necessary to protect the interests of unsecured creditors.[508] In addition, the court may appoint an estate neutral to help advise the debtor on operational and financial matters as well as the chapter 11 plan process.[509] Furthermore, the deadline to file a plan and solicit acceptances would be determined

heavy burden of proof.").

503 *Id.*; *see also Young v. Higbee Co.*, 324 U.S. 204, 210-13 (1945) (designating votes where a creditor sought special treatment); *In re Dune Deck Owners Corp.*, 175 B.R. 839, 845 (Bankr. S.D.N.Y. 1995) (designating votes where the creditor had a side agreement motivating it to reject the plan); *In re Landing Assocs., Ltd*, 157 B.R. 791, 807 (Bankr. W.D. Tex. 1993).

504 *Adelphia*, 359 B.R. at 61; *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942) ("If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand, pure malice, 'strikes' and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.").

505 Report at 279.

506 *Id*.

507 Chapter 11 currently includes some provisions designed for small businesses. In 1994, Congress added an election for "small business debtors"—currently defined as having less than $2,490,925 in liabilities—that would put them on a fast-track process. With the 2005 BAPCPA amendments, Congress made this fast-track process mandatory for small businesses and imposed additional deadlines aimed at quickly screening non-viable companies out of the chapter 11 process. *See* 11 U.S.C. § 586(a)(7)(A).

508 Report at 291.

509 *Id*.

by the court on a case-by-case basis, based on a proposed timeline submitted by the debtor within 60 days after the bankruptcy filing.[510]

The most significant change the Report recommends, however, is to eliminate chapter 11's absolute priority rule for SMEs and instead allow the prepetition equity holders of SMEs to retain ownership of the reorganized company, even where creditors have not been paid in full.[511] Under this proposal, a chapter 11 plan in an SME case could be confirmed if it provides the following treatment of allowed claims and interests:

- Administrative expenses and priority claims would be paid in full in accordance with § 1129(a)(9) of the Bankruptcy Code.

- Nonconsenting secured creditors would be treated according to the existing chapter 11 cramdown provisions, with one significant change. Secured creditors would not be permitted to elect under § 1111(b) to have their entire claim treated as fully secured. This change would allow SMEs to retain the creditor's collateral under § 1129(b)(2)(A)(i) and "write down" the secured creditor's lien to the judicially determined value of the collateral at the time the plan is confirmed, thereby allowing the SME to retain any future appreciation in the value of the collateral.

- Nonconsenting unsecured creditors would not be entitled to treatment under the absolute priority rule—and thus would not be entitled to be paid in full, even where value is distributed to prepetition equity holders—so long as the plan complies with the new "SME Equity Retention Plan" provisions.

The SME Equity Retention Plan provisions are an elaborate scheme permitting the prepetition owners of the SME to retain ownership even where the SME cannot repay all of its creditors in full. Specifically, the proposal would permit the prepetition equity holders of the SME to retain 100% of the common stock of the company—giving them control of the reorganized SME—and 15% of the economic distributions from the business (dividends and the proceeds of any liquidation, sale, or merger). The prepetition equity holders would be required to remain involved in supporting the ongoing operations of the reorganized SME. Furthermore, for three years after the effective date of the plan, the SME would be required to make annual payments to unsecured creditors of any excess cash flow, calculated in a manner reasonable in relation to the SME's operating cash flow. Finally, unsecured creditors would receive 100% of the preferred stock (or similar payment obligations) in the SME. The preferred stock would have only limited voting rights with respect to "extraordinary transactions" (changes to insider compensation; distributions to shareholders; decisions to defer or waive required distributions to the preferred shareholders; the sale, merger, or dissolution of the SME; and any amendment to the SME's organizational documents that affects the preferred shareholders' rights). Furthermore, the preferred stock would entitle unsecured creditors to receive 85% of the economic distributions from the business. The SME would have the right to redeem the preferred stock for four years after the plan's effective date by paying unsecured creditors the full amount of their allowed claims. Upon the fourth anniversary of the plan's effective date, the preferred stock would be converted into 85% of the SME's common stock.[512]

In recommending these changes, the Report contends that the current chapter 11 is failing SMEs. It cites concerns expressed by many commentators and practitioners that chapter 11 is too expensive, too complicated, and too time-consuming for small firms to navigate successfully. Furthermore, the Report asserts that chapter 11's absolute priority rule discourages SMEs from filing for chapter 11 because the rule often means that the founders of the business will lose their ownership interests in the enterprise. As a result of these factors, the Report posits that SMEs often delay filing chapter 11 or avoid filing altogether, resulting too often in liquidation through state-law receivership or assignments for the benefit of creditors or in chapter 11 § 363 sales that benefit only secured creditors. Accordingly, the Report recommends that the SME proposal be adopted to reduce the complexity of the chapter 11 process and to eliminate the absolute priority rule so that the owners of SMEs can retain their ownership stakes in their businesses.[513]

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[510] *Id.* at 294.

[511] *Id.* at 296-302.

[512] *Id.*

[513] *See id.* at 277, 281, 299-300 (stating that "many SMEs are family-owned businesses or businesses in which the founders are still actively involved," and that "SMEs find the common result of plan confirmation extinguishing prepetition equity interests in their entirety unsatisfactory or completely unworkable"; "prepetition equity views their contributions and continued participation as necessary to the reorganization,

In our view, this proposal, while well-intentioned, is misguided and should not be adopted. By eliminating the absolute priority rule to give the owners of SMEs a second chance at business success, the proposal would import into chapter 11 the "fresh start" policy that animates the Bankruptcy Code's provisions for individuals who file for bankruptcy. In individual bankruptcy cases, the Bankruptcy Code is intended to give debtors a "fresh start" through a bankruptcy discharge that eliminates old debts and frees up the individual's future earnings.[514] But that principle has no place in the Bankruptcy Code's provisions for business corporations. A corporation is not a flesh-and-blood individual, but a legal fiction holding assets that belong to the creditors and shareholders having claims against it. Accordingly, the animating principles underlying chapter 11 are very different. As discussed above, the purpose of chapter 11 is to save those businesses that can be saved—*i.e.*, those in which the assets are being put to their highest and best use and where keeping the business intact will therefore maximize value—and to distribute that value to the creditors and shareholders that own the corporation in accordance with their non-bankruptcy priorities. Where reorganization fails to maximize value and is not in the creditors' interest, there is no chapter 11 policy of giving a business corporation a "fresh start" for its own sake.[515]

The Report invokes the plight of individual entrepreneurs and founders of family-owned businesses who are actively involved in running the business and whose personal fortunes may be invested in the ownership and success of the business.[516] In the case of truly small firms or sole proprietorships, a bankruptcy filing may more closely resemble an individual bankruptcy case where fresh-start concerns are implicated. But the Report's SME proposal would extend well beyond the individual entrepreneur to mid-sized firms with assets of as much as $50 million and debts that could total hundreds of millions of dollars or more.[517] A high-tech company whose technology has become obsolete, for example, could well have assets worth little yet owe large amounts. Indeed, the Report cites data suggesting that the SME proposal would apply to 90% or more of all chapter 11 business bankruptcy filings, excluding only the very largest businesses.[518] The proposal would thus constitute a fundamental reworking of chapter 11's basic principles in the vast majority of chapter 11 cases.

To the extent that there are valid concerns about the cost and complexity of chapter 11 for SMEs, or about giving entrepreneurs a fresh start, there are far less drastic and simpler ways to address those concerns. For example, in 2010, the National Bankruptcy Conference (the NBC) released a study of SME bankruptcies in which it proposed an alternative restructuring scheme for SMEs to address many of the same concerns identified by the Report. Like the Report, the NBC pointed to concerns expressed by judges, practitioners and academics that "Chapter 11 works poorly or not at all for small businesses."[519] It cited concerns that chapter 11 is too expensive and complicated for SMEs, that the founders of small businesses avoid chapter 11 because they may lose their ownership interests, and that SMEs too often liquidate under unsatisfactory state-law procedures instead of chapter 11.[520]

But in contrast to the Report, the NBC proposed a much simpler solution. It proposed that the existing provisions of chapter 12 for bankruptcy filings by small farming businesses be extended to apply to all small businesses. As it observed, chapter 12 is "a time-tested, successful model for efficient reorganization of small busi-

but stakeholders may hold a very different perspective"; "[p]repetition equity or managers may be considered part of the problem or ineffective. … SMEs needed a reorganization path that encouraged founders and prepetition equity not only to invoke chapter 11, but also to devote all of their efforts to the debtor's successful reorganization. Indeed, for many SMEs—whether stakeholders like them or not—the prepetition founders or managers often possess the knowhow and relationships necessary to facilitate a successful restructuring of the business").

514 *See* 11 U.S.C. §§ 522, 523, 524, 541(a)(6), 727, 1141(d)(5), 1328.

515 *See* Douglas G. Baird, *Elements of Bankruptcy* 57-59 (6th ed. 2014) ("The rhetoric of the fresh start often creeps into discussions of Chapter 11, but one should not be misled by the notion of 'rehabilitating' a corporate debtor.")

516 *See* Report at 276, 300.

517 The Report would permit a firm to qualify as an SME if it has assets *or* liabilities of $50 million or less, meaning that an insolvent company could qualify for SME treatment so long as its assets were equal to $50 million or less, even if its debts were well in excess of $50 million *Id*. at 279. In contrast to the high thresholds the Report recommends for SME status, recent empirical data suggests that the businesses having the most difficulty confirming and completing a Chapter 11 plan are those with less than $2 million in liabilities. *See* Anne Lawton, *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success*, 54 Ariz. L. Rev. 985, 1018-22 (2012) (finding that debtors with more than $2 million in liabilities are significantly more likely to complete their plan successfully than those with less than $2 million in debt).

518 Report at 287-88.

519 National Bankruptcy Conference, *A Proposal for Amending Chapter 12 to Accommodate Small Business Enterprises Seeking to Reorganize* 1 (Jan. 3, 2010), available at http://www.national bankruptcyconference.org/images/NBC%20Small%20Business%20Rept%20Dec%20 17,%202009.

520 *Id.* at 1-9, 11.

nesses" that is simpler and more streamlined than chapter 11.[521] Chapter 12 does not provide for the appointment of creditor committees, does not require the debtor to prepare a disclosure statement, does not require the solicitation of creditor votes, and permits administrative expenses to be paid over time rather than in full in cash on the plan's effective date.[522] Furthermore, chapter 12 permits the prepetition owners of the business to retain ownership of the business so long as (1) nonconsenting secured creditors receive their collateral or are paid its present value over the life of the plan, and (2) unsecured creditors receive at least as much as they would in a chapter 7 liquidation and are paid all of the business's disposable income for up to five years after the effective date of the plan.[523] The NBC asserted that this proposal could be implemented through a relatively small number of amendments to the existing provisions of chapter 12.[524]

To the extent that there may be problems with the existing provisions of chapter 11 for SMEs, the NBC's proposal is a thoughtful proposal that deserves attention. But, in our view, adopting the Report's alternative proposal would be a mistake. Although the Report emphasizes the need to simplify the chapter 11 process for SMEs, the SME Equity Retention Plan proposal would add considerable complexity to the plan process. The proposal would require SMEs to adopt a complicated capital structure of common and preferred stock with detailed voting and distribution rights, likely adding expense and complexity both to the plan process itself and to the SME's ability to execute the plan after emerging from bankruptcy. Moreover, the proposal would seriously damage chapter 11 by abandoning its most basic principle, the absolute priority rule, in all but the very largest chapter 11 cases (where the absolute priority rule would be separately undermined by the Report's redemption option value proposal). The Report fails to offer any compelling justification for taking such a drastic step here, particularly when it has failed to explore simpler solutions put forth by others that may adequately address the concerns it cites without doing violence to the basic operation and founding principles of chapter 11.

I. Additional Proposals

While the preceding sections of this Response have addressed some of the Report's proposals with which the LSTA disagrees, the Report also includes a number of specific proposals with which the LSTA agrees. We address three specific proposals below: those relating to a secured creditor's right to credit-bid, the proper rate of interest to which a secured creditor is entitled when its claim is subject to cramdown, and the "new-value corollary" to the absolute priority rule.

1. Credit-Bidding

Under chapter 11, when a secured creditor's collateral is sold, either through a § 363 sale or through a sale conducted under a plan, the creditor is entitled to "credit-bid" its claim in the sale, meaning that, rather than bidding in cash, the creditor can set off up to the full amount of its claim against the purchase price.[525] Credit-bidding is a critical part of the protections chapter 11 grants secured creditors to ensure that they receive the full value of their collateral and that, when possible, that value is determined through the marketplace.[526] Specifically, credit-bidding ensures that, if a secured creditor's collateral is sold and the secured creditor values it more highly than the next highest bidder, the creditor can take the collateral itself rather than the cash that the sale would otherwise generate—reflecting secured creditors' rights outside bankruptcy.[527]

A bankruptcy court can deny the right to credit-bid only for "cause."[528] For most of the Bankruptcy Code's history, "cause" has been narrowly construed.[529] Recently, however, two widely discussed bankruptcy court deci-

[521] *Id.* at 1. As the NBC Proposal notes, chapter 12 was enacted to address similar concerns about the effectiveness of chapter 11 for small farming businesses. *See id.* at 8.

[522] *Id.* at 9-13; 11 U.S.C. §§ 1221-1228.

[523] NBC Proposal at 9-13; 11 U.S.C. §§ 1222(b), 1225(a)(4)-(5), (b).

[524] NBC Proposal at 1, 15-16, Appendix (listing proposed amendments). In fairness, struggling small businesses that lack regular income might well present more complex issues than the NBC proposal contemplates.

[525] *See* 11 U.S.C. §§ 363(k), 1129(b)(2)(A)(ii); *RadLAX*, 132 S. Ct. at, 2073.

[526] *See* Spinelli, *supra* note 6 (describing history and purpose of credit-bidding).

[527] *See id.*

[528] 11 U.S.C. § 363(k).

[529] *See* Donald S. Bernstein et al., *The Logic and Limits of Credit Bidding by Secured Creditors under the Bankruptcy Code*, 8 (N.Y.U. work-

sions have seemingly employed a broader standard for "cause."[530] In *Fisker Automotive Holdings*, the court held that there was "cause" to limit credit-bidding where allowing the secured creditor to bid the full amount of its claim would purportedly chill other bidders from participating in the auction.[531] And in *Free Lance-Star Publishing Co.*, the court limited a secured creditor's right to credit-bid based on, among other things, what the court viewed as the creditor's "overly zealous loan-to-own strategy."[532]

The Report recommends retaining secured creditors' current right to credit-bid in sales of their collateral.[533] In response to the questions raised by decisions like *Fisker* and *Free Lance-Star*, the Report also recommends clarifying what constitutes "cause" under § 363(k) to deny a secured creditor the right to credit-bid. Specifically, the Report proposes that "the potential chilling effect of a credit bid alone should not constitute cause" to deny credit-bidding.[534] Although the Commission believes that "all credit bidding chills an auction process to some extent," it recommends that courts address any potential chilling effect through control of the auction and sale procedures.[535]

The LSTA agrees with the Commission's proposal, which reflects secured creditors' basic right to the value of their collateral. As the Commission observes, "credit bidding is an integral part of the secured creditors' rights package."[536] By allowing a secured creditor to take the collateral when it values the property more highly than a third-party purchaser, credit-bidding is essential to protecting the secured creditor's basic bargain to be paid in full or receive the collateral. The notion that credit-bidding might "chill" third-party participation in the sale is not a valid basis on which to deny the right to credit-bid. As an initial matter, the "chilling" effect of credit-bidding is dubious. If bidders who are not willing to pay the amount of the credit-bid are "chilled," that has no consequence for the estate. And bidders who are willing to pay more than the amount of the credit-bid have no reason to be chilled. In this regard, the "chilling" effect of a credit-bid is no different than the "chilling" effect of a cash bid. "[N]o auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."[537] In any event, even if credit-bidding somehow caused a chilling effect, the secured creditor has the basic right to take its collateral if it is not paid in full, and chapter 11 respects—and should respect—that right.

2. Cramdown Interest Rates

The Report recommends that when a debtor seeks to "cram down" a secured creditor under a chapter 11 plan by refinancing the secured debt and paying the creditor with a stream of future payments, the debtor must pay a market rate of interest if such a rate is available; otherwise, the rate should be "an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor."[538] The Report specifically urges that the "prime plus" method adopted for chapter 13 cases in *Till v. SCS Credit Corp.*[539] not be used in chapter 11.[540] We agree with this recommendation.

As discussed above, when a debtor seeks to confirm a chapter 11 plan over the dissent of a secured creditor, the Bankruptcy Code requires that the creditor be paid its secured claim in full. Thus, when a debtor seeks to repay the secured creditor over time, the Bankruptcy Code requires that the future stream of payments have a present

ing paper 2011) (explaining that "cause to deny the secured creditor's right to credit bid is rarely found to exist" and courts had found cause in cases involving a secured creditor's bad faith or collusion with the debtor; failure to follow sale procedures; a bona fide dispute regarding the validity of a lien; or prejudice to other lienholders).

[530] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55 (Bankr. D. Del. 2014); *In re Free Lance-Star Publishing Co. of Fredricksburg, Va.*, 512 B.R. 798 (E.D. Va. 2014).

[531] *Fisker*, 510 B.R. at 60.

[532] *Free Lance-Star*, 512 B.R. at 807.

[533] Report at 146.

[534] *Id*.

[535] *Id.* at 146-47.

[536] Report at 146.

[537] *See* Spinelli, *supra* note 6, at 19-20; Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 Geo. Mason L. Rev. 99, 122-24 (2010).

[538] Report at 234.

[539] 541 U.S. 465 (2004).

[540] Report at 234.

"value" equal to the value of the secured creditor's collateral.[541] For example, if the debtor proposes to pay a fully secured creditor owed $100 with a note that repays the $100 five years later, the note must bear a rate of interest sufficient to make the "value" of the deferred payment of the $100, plus the interest, equal to $100 today. Under basic principles of finance, for those payments to have a present "value" equal to the secured creditor's claim, the note must bear a market rate of interest, where such a rate is available.[542]

Accordingly, the majority of courts have concluded that a market rate of interest should be used in chapter 11 cramdown plans where an efficient market exists.[543] One recent decision held to the contrary, reading the Supreme Court's decision in *Till* to require the use in chapter 11 of the "prime plus" formula that *Till* adopted in chapter 13, which uses the prime rate plus a judicially determined risk premium.[544] *Till* involved a subprime auto loan with an original interest rate of 21%.[545] In that context, the *Till* plurality concluded that "there is no readily apparent Chapter 13 'cramdown market rate of interest'" and accordingly adopted the formula approach.[546] Whatever the merits of this reasoning in the chapter 13 consumer finance context, however, *Till* expressly noted that "the same is not true in the Chapter 11 context"; "[t]hus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce."[547]

We agree with the Report's recommendation that courts should use a market rate of interest, rather than the *Till* formula, to determine the appropriate interest rate on a cramdown note in chapter 11. The fundamental principle underlying chapter 11's treatment of secured creditors is that a secured creditor is entitled to be paid in full or to receive the full value of its collateral, consistent with its rights under nonbankruptcy law. Thus, when a debtor elects to retain the secured creditor's collateral and repay the secured debt with a new note, that treatment should be the equivalent of being paid in full in cash on the plan's effective date. And the only way to ensure that requirement is met is to use a market rate of interest. Put differently, if a creditor with a secured claim of $100 is crammed down under a chapter 11 plan and given a note, it should be able to sell that note for $100 in cash; if it cannot do that, it is not receiving the equivalent of $100 in cash today, as the statute requires. And selling the note for $100 will be possible only if the note bears a market rate of interest; otherwise, potential buyers will invest their $100 elsewhere. To the extent that the "prime plus" approach yields an interest rate that is below market, it does not compensate the secured creditor as the statute requires; the creditor is not receiving the full value of its collateral. As *Till* itself suggests, then, it is wrong to apply the "prime plus" formula mechanically to a chapter 11 case where the market rate is discernible.

3. The New-Value Corollary

The Commission proposes to codify the so-called "new-value corollary." The new-value corollary is a doctrine under which prepetition equity-holders (who would under the rule of absolute priority be the most junior class in the Bankruptcy Code's distribution waterfall) may retain some equity interest in the reorganized debtor, notwithstanding that senior classes have not been paid in full, to the extent that old equity contributes new capital to the reorganized debtor.[548] The theory is that to the extent the prior equity-holder retains an equity stake in exchange

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[541] *See* 11 U.S.C. § 1129(b)(2)(A)(i)(II).

[542] *See* 7 *Collier on Bankruptcy* ¶ 1129.05[2][b] ("[W]hen the interest rate on [a cram-down note] equals the discount rate," the note "has a present value equal to its face amount. Since market conditions affect ... the applicable discount rate, … if the note bears a market rate of interest, the market will discount that note at the same rate, and the present value of the note will be its face amount." (citing H.R. Rep. No. 95-595 at 415 (1977))); *id.* ¶ 1129.04[2][a][ii] ("[I]f the [debtor] chooses a rate which is less than the 'market' rate[,] then the stream of payments will not have a present value equal to the allowed amount of the claim.").

[543] *See, e.g.*, *In re American HomePatient, Inc.*, 730 F.3d 559, 568 (6th Cir. 2005); *In re 20 Bayard Views, LLC*, 445 B.R. 83, 107-08 (Bankr. E.D.N.Y. 2011); *SPCP Grp. LLC v. Cypress Creek Assisted Living Residence Inc.*, 434 B.R. 650, 660 (M.D. Fla. 2010); *In re Brice Rd. Dev., L.L.C.*, 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008); *Mercury Capital Corp. v. Milford Conn. Assocs.*, 354 B.R. 1, 11-12 (D. Conn. 2006); *In re Seaspan Dev. Corp.*, No. 05-CV-315, 2006 WL 2672298, at *2-3 (E.D. Tenn. Sept. 18, 2006); *In re Bryant*, 439 B.R. 724, 740-43 (Bankr. E.D. Ark. 2010); *In re Bashas' Inc.*, 437 B.R. 874, 920 (Bankr. D. Ariz. 2010); *In re Nw. Timberline Enters.*, 348 B.R. 412, 432, 435 (Bankr. N.D. Tex. 2006); *In re Deep River Warehouse, Inc.*, No. 04-52749, 2005 WL 2319201, at *11 (Bankr. M.D.N.C. Sept. 22, 2005); *In re Prussia Assocs.*, 322 B.R. 572, 588-89, 604 (Bankr. E.D. Pa. 2005).

[544] *See In re MPM Silicones, LLC*, 2014 WL 4436335, at *24-29 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015).

[545] *Till*, 541 U.S. at 470.

[546] *Id.* at 478-80.

[547] *Id.* at 476 n.14.

[548] *See Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 442-43 (1999).

for providing new value, that equity is not being provided “on account of” the prior equity position.[549]

The Supreme Court signaled its approval of the new-value corollary in the *North LaSalle* case—at least subject to safeguards designed to ensure that old equity is truly paying full value for the interest which it receives.[550] The Court made clear that, to ensure that the opportunity to obtain the equity stake in the reorganized debtor is truly independent of the prior equity position, the new value should be subject to a market test, but did not elaborate on the precise contours of such a market test.

The Commission now proposes to codify the new-value corollary for cases where equity contributes:

i. “new money or money’s worth”;

ii. in an amount that is “reasonably proportionate” to the equity received or retained by prepetition equity security holders;

iii. “subject to a reasonable market test” (not further defined by the Commission, but to be determined on a case-by-case basis according to “the facts, the evidence presented, and what would be reasonable in the particular case before the court”).[551]

We believe this standard is, in broad strokes, correct. As the Supreme Court observed, absolute priority means that, so long as creditors are not being paid in full, the old owners of the firm cannot receive value “on account of” their prior ownership.[552] To the extent a plan permits an old equity-holder to acquire an ownership stake in the new firm on the same terms made available to anyone else, one can be confident that absolute priority is satisfied. Where the investment opportunity is not provided to others, more difficult questions arise. In those circumstances, courts must take a hard look to ensure that the old owners are not receiving any type of preferential treatment or other benefit on account of their prior ownership.

The precise manner in which courts satisfy themselves that this standard has been met is likely highly dependent on the facts and circumstances of individual cases, and thus not amenable to a single formulation. But the Commission is clearly correct that the value must be subject to a “reasonable market test.”

Our only reservation regarding the Commission’s formulation of the new-value corollary is its proposal that the new value must be “reasonably proportionate” to the equity retained or received by the old owner. In our view, the value should be at least equal to the equity retained or received by the old owner; otherwise, it is impossible to be sure whether absolute priority is truly being respected. Subject to that point, we agree with the Commission regarding new value.

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[549] *Id.* at 456; *see* 11 U.S.C. § 1129(b)(2)(B)(ii) (providing that, absent consent, a class of unsecured claims may be not paid in full only if “the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property”).

[550] *203 N. LaSalle*, 526 U.S. at 457.

[551] Report at 226.

[552] *203 N. LaSalle*, 526 U.S. at 456.

CONCLUSION

The Commission has said from the outset that it sought to "balance" the "rights of senior creditors" against "the reorganization needs of the debtor and the interests of other stakeholders."[553] The Report notes that the members of the Commission had diverse views, and candidly acknowledges areas on which Commissioners disagreed, explaining that those issues were the subject of extensive discussion and ultimately of compromise among the Commissioners. In the Commission's view, because no constituency got everything it wanted—and because some of its proposals are favorable to secured creditors—the Report strikes an appropriate "balance."

We disagree. In our view, it is fundamentally mistaken to view bankruptcy law as a mere scale in which one seeks to strike the right "balance" among competing constituencies. We think it is misguided to say that developments in the marketplace have given one set of parties undue "leverage," and to try to rewrite the Bankruptcy Code to recalibrate the proper "balance."

To build a coherent bankruptcy law, one must identify the basic principles that should underlie the Code and then implement those principles throughout the Code in a way that is clear and consistent. A statutory scheme constructed in this manner, as the 1978 Bankruptcy Code was, provides a tool for resolving questions that may not be addressed expressly by the statutory language—one can look to the basic principles, the "architecture" of the Code, as a guide to resolve ambiguities. That in turn permits bankruptcy law to provide a clear backdrop against which parties can order their commercial interactions. That design is frustrated, however, if the animating principle is to shift rights from one side of the ledger to the other until a consensus emerges that, from the perspective of "subjective fairness," a proper "balance" has been struck.

As we explain above, chapter 11 as it exists today is based on clear and simple principles. The goal is to maximize the value of the enterprise. The Code does not have a substantive vision of a "fair" distribution of that value; rather, it allocates value in accordance with the parties' nonbankruptcy entitlements and priorities. For a secured creditor, that means it is entitled to its collateral or any value derived from its collateral until it is paid in full. For an unsecured creditor, that means that—pursuant to the absolute priority rule—it is entitled to be paid in full before old equity receives or retains any property on account of its equity interest. The "minimalist" nature of bankruptcy law means that it interferes with nonbankruptcy rights and agreements only to the extent necessary to further bankruptcy's central goals of maximizing value and giving the parties a fair forum in which to vindicate their nonbankruptcy entitlements against a limited *res*.

As we have discussed, some of the Commission's recommendations are consistent with these principles. Other recommendations, however, including the Commission's suggested revisions to adequate protection and its redemption option value proposal, break sharply from these basic tenets. If the Commission's proposals were adopted, bankruptcy law would be deprived of its coherent architecture. Even aside from the proposals' potentially harmful effects on the broader economy and financial markets, therefore, adopting them would be a significant step backward for federal bankruptcy law and practice.

[553] Report at 214.

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