American Bankruptcy Institute (ABI) Reform Commission Releases Report Recommending Significant Changes to Chapter 11

On December 8, 2014, the American Bankruptcy Institute (ABI) Commission to Study the Reform of Chapter 11 published a 400-page report containing far-reaching recommendations. The report is the result of a three-year study process undertaken by a number of leading insolvency and restructuring practitioners charged by ABI with evaluating the U.S. business reorganization laws and proposing reforms “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.”

The stated goals of the report are not just to further inform the dialogue surrounding chapter 11 reform and to add to the debate surrounding these important issues, but also to encourage policymakers to consider and adopt the recommendations and principles outlined in the report. Below is a summary of some, but not all, of those principles and recommendations.

It is unclear whether any of the report’s recommendations will be introduced in legislation before Congress or if Congress will make bankruptcy reform a high priority in the coming year, but given the in-depth analysis contained in the report and the nature of the parties who took part in the Commission’s activities, we can expect there to be significant discussion on these issues in the restructuring community beginning immediately.

Amount of adequate protection necessary to protect secured creditor is determined using the “foreclosure value” of the collateral.

- Foreclosure value is not liquidation value. It is defined as “the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor’s collateral under applicable nonbankruptcy law.”

- In a foreclosure sale where the secured creditor is credit bidding, secured creditor must use the net cash value that it would realize upon a hypothetical, commercially reasonable foreclosure sale, not the face amount of the debt.

Confirmation issues.

- The section 1129(a)(10) requirement of an impaired accepting class will be completely eliminated in all chapter 11 cases.

  - The stated goal is to focus on rehabilitation and eliminate incentives for distortive or tactical behavior that has nothing to do with the outcome of the business, such as fighting over classification and buying a voting block to stop the restructuring.
• Creation of one creditor, one vote standard — if a creditor buys 10 claims at the same entity, it only gets one vote.

• Condemnation of gifting.

• Third party releases are acceptable if the Master Mortgage requirements are met.

• Codification of exculpation for professionals, which already is customary.

• Retention of the absolute priority rule, but addition of option value for the “immediately junior class” that is out of the money. If, after emergence, a company has upside during the measurement period, it should go to the junior creditors. The goal is to provide an incentive to creditors to want rehabilitation.
  – The upside is not at the expense of secured creditors, however. Oversecured creditors must still be paid in full.

• For plan and section 363x purposes, courts will use “reorganization value” to measure the value of collateral.

• For cramdown, the Commission rejected the Till “prime plus” formula and adopted a market based standard. If there is no market, use the risk adjusted rate (determined using the traditional factors involved in pricing a loan).

**Increase governance options with the addition of a new professional called an “estate neutral” and eliminate the mandatory examiner provision.**

• The current examiner provision is too limited, so the appointment of an estate-compensated “estate neutral” with greater powers than an examiner (but less than a trustee) will be more helpful.

• An estate neutral is appointed by the court after a determination whether it is in the best interests of the estate.
  – The U.S. Trustee will appoint the person, but the court will define the duties and the duration of the appointment, which will vary on a case-by-case basis. The estate neutral could be appointed to help facilitate the resolution of disputed matters or expedite matters, but should not be used as a mediator in matters affecting the case unless that is the principal purpose of the appointment.

• The recommendations clarify that the burden of proof necessary for appointment of trustee is a preponderance of the evidence.
Creation of a new section 363x to address sales of all, or substantially all, of a debtor’s assets outside of a plan.

- New section 363x reflects the Commission’s view that in some cases, there is a legitimate concern about deterioration of assets, which necessitates a quick sale, but many quick sales are strategic or tactical decisions by stakeholders that do not allow sufficient time for valuation or price discovery.

- The new section will have a moratorium on a sale for the first 60 days, with a relief valve if there is significant value deterioration, but there is a high bar to prove it. Parties will need evidence satisfying the clear and convincing standard to overcome the 60-day moratorium.

- There will be tandem provisions that apply to financings, so that lenders cannot avoid the operation of section 363x with financing milestones.

Debtor must prepare a “valuation information package” (VIP) in connection with financing or sale motions filed within the first 60 days of the case.

- The VIP will be available to any creditor requesting it for a “proper purpose” and may be redacted unless the court orders otherwise.

Professional compensation.

- Separate ordinary course professionals (OCPs, referred to as “nonbankruptcy professionals”) from bankruptcy professionals and eliminate “OCP” orders.

- Require transparency with respect to all fees, whether paid to creditors or professionals.

- Encourage courts and professionals to be creative and use alternative billing arrangements.

- Provide for alternative billing arrangements, as well as for backside protections and the elimination of lodestar.

Treat all intellectual property (IP) the same, including trademarks and foreign trademarks, patents and copyrights.

- All IP should be available to creditors and freely assignable, with one exception: if assigning IP to a competitor, there will be a higher standard necessary to avoid licensor protections.

- The recommendations would eliminate the circuit split and the complicated “actual versus hypothetical” test and “exclusive versus non-exclusive” license determination.

Significant modifications to employee wage provisions.

- Provide for ordinary course payment of employee wages and benefits without a first-day wages motion and order.

- Increase priority of individual wage claims up to $25,000 and combine current sections 507(a)(4) and (a)(5).
• Eliminate 180-day measuring period.

Sections 1113 and 1114 will be modified to encourage more bargaining and save jobs.
• Emphasis is on rehabilitation and consensus.

Creation of a new chapter 11 paradigm for small and middle-sized enterprises (SMEs).
• Companies with $10 million or less of assets or liabilities must be treated as SMEs, and there is a presumption that no official committee of unsecured creditors will be appointed.
  – Instead, the court may appoint an estate neutral who is tailored to the circumstances (financial advisor, sale monitor, etc.) and limit his/her budget.
• Companies with $10 million to $50 million of assets or liabilities may elect SME treatment, and the court must decide whether to permit them to receive it.
• SME provisions will affect 80-90 percent of chapter 11 cases that are filed. In other words, it will become the new normal for most chapter 11 cases.
• Secured debt and priority creditors are treated the same in SME cases as they are now, but there are significant changes to the absolute priority rule.
  – Under the proposed reforms, owners can retain their interest if non-priority creditors get 85 percent of the enterprise, in a classic debt-for-equity swap.

The section 1111(b) election is replaced by the concept of the 85 percent equity interest.

Section 546(e) is amended to remove protection for beneficial owners of privately issued securities in connection with leveraged buy-outs or other prepetition transactions using some or all of the debtor’s assets to facilitate the transaction.

Trade provisions.
• Section 503(b)(9) protection remains unchanged but drop shipment is included where proven. Service providers are not eligible for section 503(b)(9) protection.
• Part of the compromise evident in the trade recommendations is the elimination of a state law reclamation remedy and loss of critical vendor status for parties asserting a 503(b)(9) claim.
• Preference provisions are generally unchanged except that $25,000 is the minimum claim to bring a preference action and preference defendants in actions worth less than $50,000 must now be sued where the defendant resides.

Real property provisions.
• A debtor’s time under section 365(d)(4) to assume or reject unexpired nonresidential real property leases will be extended from 210 days to one year after the petition date or the relief date.
• Section 502(b)(6) should define “rent” as “any recurring monetary obligations of the debtor” and not rely on whether the obligation is labeled as “rent” under the lease.

Resolution of chapter 11 cases.
• A chapter 11 case may only be resolved by confirmation under section 1129, conversion under section 1112 or dismissal subject to section 349.

Commission does not take a position on the venue debate.
• Delaware and New York bankruptcy courts transfer venue 75 percent of the time when a motion is made, which suggests they are able to police venue shopping themselves.

• By eliminating circuit splits, the Commission hopes to avoid venue decisions driven by the splits.

Commission also does not take a position on the “article III versus article I” debate.
• There is a white paper section of the report regarding venue, jurisdiction, individual chapter 11, cross-border and other issues.
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