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Distressed Mergers and Acquisitions

2019

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Introduction

The topic of this outline is mergers and acquisitions where the target company is "distressed." Distress for this purpose means that a company is having difficulty dealing with its liabilities—whether in making required payments on borrowed money, obtaining or paying down trade credit, addressing debt covenant breaches, or raising additional debt to address funding needs.

Distressed companies can represent attractive acquisition targets. Their stock and their debt often trade at prices reflecting the difficulties they face, and they may be under pressure to sell assets or securities quickly to raise capital or pay down debt. Accordingly, prospective acquirors may have an opportunity to acquire attractive assets or securities at a favorable price. This outline considers how best to acquire a distressed company from every possible point of entry, whether that consists of buying existing or newly issued stock, merging with the target, buying assets, or buying existing debt in the hope that it converts into ownership.

Some modestly distressed companies require a mere "band-aid" (such as a temporary waiver of a financial maintenance covenant when macroeconomic forces have led to a temporary decline in earnings). Others require "major surgery" (such as where a fundamentally over-levered company must radically reduce debt).

Before discussing the law and practice of distressed acquisitions, we undertake a review of corporate responses to debt crises, each of which can provide an important entry point for a would-be acquiror. Part I explores initial corporate responses to distress. For companies with adequate liquidity and no looming debt maturities, options for dealing with distress include negotiating forbearance agreements, waivers, and amendments of bank and bond debt. These responses are discussed in Part I.A.

Companies facing significant liquidity problems and impending debt obligations may be able to pursue non-bankruptcy solutions, but will likely need to respond to their distress in ways that dilute the existing equityholders' ownership of the distressed company or its assets. Examples of such responses include asset sales, PIPE investments, rights offerings, debt repurchases or restructurings, exchange offers, and foreclosure sales. Such undertakings provide opportunities for a potential investor to acquire interests in, assets from, or control of the distressed company. However, dealing with a company facing this level of distress also entails numerous risks. Part I.B highlights the potential benefits and risks of working with a company on the verge of bankruptcy, and describes ways to mitigate risk and capture potential benefits.

Out-of-court transactions like those described in Part I.B tend to be less costly and time-consuming than in-court transactions, but they often require shareholder approval or creditor consensus—and non-consenting parties typically cannot be bound against their will to changes in their fundamental rights (*e.g.*, a reduction of principal or interest or an extension of maturity of an obligation owed to a creditor).

By contrast, a transaction executed pursuant to the U.S. Bankruptcy Code can bind non-consenting parties and does not require shareholder approval. Therefore, in-court solutions are often imperative for firms experiencing acute distress.

Part II of this outline discusses hybrid approaches such as "prepackaged" and "pre-negotiated" bankruptcy reorganization plans. These plans are appropriate for troubled companies with sufficient lead time to engage in out-of-court bargaining prior to acute distress. They tend to result in cheaper, faster, less confrontational bankruptcies with less damage to the business (less impact on trade credit terms, less risk of outright loss of suppliers, less reputational harm with customers, fewer employee defections, etc.). Sometimes the mere fact that a borrower is prepared to file bankruptcy brings dissenting creditors into line and makes a fully out-of-court solution possible.

Part III of this outline discusses acquisitions of companies in and through bankruptcy. Asset sales in bankruptcy—addressed in Part III.A—may be consummated pursuant to section 363 of the Bankruptcy Code on an expedited basis. Although such sales (commonly referred to as "363 sales") were traditionally disfavored by courts where the assets to be sold constituted a significant portion of a bankrupt company's business, and time was not of the essence, more recently many business debtors have been allowed to sell substantially all of their assets despite having a lengthy liquidity runway. Another option is the acquisition of a bankrupt company, or a significant portion thereof, by creditors or outside investors through implementation of a reorganization plan. This scenario is addressed in Part III.B.

Part IV of this outline addresses specific considerations regarding trading in claims against distressed companies. Claims trading can be a strategy for obtaining control (*e.g.*, by buying claims that can be used as consideration in a section 363 sale or that may receive ownership of the restructured company under a plan of reorganization) or an investment opportunity for the trader with a shorter-term horizon. For either class of investor, trading claims presents risks and opportunities that generally do not exist for acquirors of the debt of non-distressed companies.

Regardless of an investor's ultimate point of entry, a good first step when considering a transaction with a distressed company is to hire counsel familiar with the process. Counsel will be able to review all relevant documentation, determine whether collateral has been properly secured and perfected, expose vulnerabilities, find opportunities, and safeguard against undue risk.

We welcome your comments or questions on this outline.

I.

Out-of-Court Workouts of Troubled Companies

A variety of circumstances may indicate financial distress. Among other signs, companies may have triggered or be close to triggering financial covenants in their debt agreements. They may also find themselves unable to deliver clean (unqualified) audit opinions, or satisfy material adverse effect or solvency-related conditions in order to a draw on a revolving line of credit. Impending debt maturities, even for healthy companies, may be potential sources of financial difficulty depending on the state of the capital markets.

Well before a crisis erupts and thoughts turn to bankruptcy, a distressed company may try to mitigate its exposure by seeking amendments or waivers to its credit facilities or debt securities. If those options are not sufficient, then it may take other measures, such as attempting to exchange its existing debt for new debt or equity in the company, selling assets, or raising equity capital.

The nascent stages of a company's distress present an opportunity for an interested investor to gain leverage. An investor that purchases or already holds debt of a distressed company can use the company's need for forbearances and waivers as leverage to require the company to take certain steps, such as providing additional collateral, making significant payments, selling assets or engaging in control-changing transactions. Part I of this outline surveys actions that a distressed company may take short of a bankruptcy filing, and the opportunities that such actions create for investors.

A. Initial Responses to Distress

1. Forbearance

Financially troubled companies that have breached debt covenants or determine that they are imminently likely to do so may initially approach their creditors to seek forbearance. A forbearance is an agreement by a lender to refrain from exercising certain rights that are available to it under a credit agreement or indenture as a result of an event of default. A forbearance typically is not permanent. After the period of forbearance is over, a lender may exercise any of its rights or enforce any of its remedies.

A forbearance is generally a first step to a waiver or amendment, if not a refinancing of the defaulted debt. It is useful as a stopgap measure to permit a lender to assess its position *vis-à-vis* both the distressed company and other

creditors. The forbearance period can be used to enter into more advanced negotiations within and among creditor constituencies and with the distressed company, and to undertake due diligence, free from concerns that other lenders will use the period of forbearance to exercise their remedies and gain a relative advantage. When the forbearance period ends, each debtholder can decide what steps to take next based on careful investigation and consideration of its options during the forbearance period.

Because a forbearance is not a waiver of the underlying event of default, during the period of forbearance, (a) interest typically continues to accrue at the rate applicable after an event of default has occurred; (b) the continued existence of an event of default generally makes it impossible for the company to draw on lines of credit; (c) cross-defaults to other financial instruments may be triggered; and (d) there may be concern among vendors, business partners, and the financial community about the long-term viability of the enterprise. The possibility of default in other credit documentation, including through cross-defaults, is a significant concern. A lender considering forbearance frequently will condition such forbearance on all other lenders that could assert a default also agreeing to forbear during the specified period.

2. Waivers and Amendments

a. *Basics of Waiver and Amendment*

A waiver is an agreement to suspend enforcement of one or more provisions of an agreement; it can be either temporary or permanent in duration. It differs from a forbearance in that compliance with the underlying obligation is excused, while in the case of a forbearance, a lender merely agrees to refrain from enforcing its remedies for noncompliance. After a temporary waiver expires, the breach returns to unwaived status and lenders may enforce rights and remedies in respect of the breach.

Waivers should be contrasted with amendments. While a waiver merely excuses a breach, an amendment operates to modify the underlying agreement. Amendments are used to modify existing agreements for a variety of reasons, including to make financial covenants more realistic in light of current economic conditions, to modify restrictions on incurring additional debt or issuing new equity, or to allow or require dispositions of business units.

b. *Implications of Obtaining Consents*

Modification of a credit agreement or indenture requires consensus among holders of a contractually specified percentage of the debt. Required approval thresholds vary among indentures and credit agreements, and also among the various types of modifications. Starting at the lowest threshold, indentures generally have a category of amendments that can be made without the consent of bondholders, such as adding covenants and events of default and taking other actions that benefit the bondholders. Most substantive waivers and modifications for both bank debt and bonds require holders of a majority in principal amount of the outstanding debt to consent. Certain core waivers and amendments, such as waiving principal or interest payments, releasing substantially all collateral, or extending maturities, generally require unanimous approval (or at least the approval of each affected lender) and, in practice, are very difficult to obtain.

The process of negotiating and obtaining waivers or amendments may raise important federal securities law issues for the issuer, debtholders, and potential debt purchasers. In order to procure the requisite lender consents, an issuer of public debt securities typically will undertake a consent solicitation. Depending on the nature of the requested amendments and the consideration an issuer is willing to offer in order to obtain debtholder consents, solicitations may be coupled with a tender or exchange offer and thus be subject to the requirements of Regulation 14E promulgated under the Securities Exchange Act of 1934 (as amended, the "Exchange Act"), as discussed in more detail in Part I.B.4 of this outline.

Furthermore, if a distressed company has issued public securities—regardless of whether the debtor is seeking to amend those securities—federal securities laws, including the antifraud and fair disclosure requirements of Rule 10b-5 and Regulation FD, will impact the behavior of the company and its debtholders. Regulation FD prohibits issuers from making selective disclosure of material nonpublic information, and Rule 10b-5 prohibits trading on the basis of material nonpublic information. Thus, creditors (and potential investors) seeking nonpublic information in order to evaluate and negotiate a waiver or amendment request will be required to agree to keep that information confidential and will not be permitted to trade in the debtor's securities while in possession of such material nonpublic information.[1] For this reason, such creditors and investors

[1] Credit agreements often provide for dissemination of information to two separate classes of lenders: those who elect to receive only public information and may freely trade in the debtor's securities and those who elect to receive nonpublic information and are therefore restricted from

may insist that such information be made public in due course, allowing trading to resume.

In evaluating the level of consent required to obtain an amendment as well as the effect of a proposed amendment, issuers and investors must consider any limitations on the voting status of outstanding debt. A borrower (or an affiliate of the borrower) that is able to obtain and vote a large percentage or a majority of its own debt may be able to strip covenants and other protections from remaining debtholders. Under the Trust Indenture Act of 1939 (the "TIA"), bonds owned by the issuer and its affiliates are not considered outstanding for purposes of calculating the vote required to direct the trustee to act upon a default, to waive a default, or to consent to postponement of interest.[2] Under the TIA, affiliate votes may be counted for other amendments (*e.g.*, covenant strips); however, as a matter of practice, many indentures exclude affiliate votes in all circumstances. With bank credit agreements, the question of voting is decided by contract. While historical strictures on purchases of bank debt by issuer affiliates have loosened considerably, it remains taboo, as a general matter, for such affiliates, including private equity sponsors, to vote their purchased debt.

Yet even in credit agreements that purport to restrict voting by a borrower and its affiliates, the language typically does not prevent informal arrangements whereby parties that have relinquished an economic stake in the debt effectively defer to their transferees. Credit agreements generally are drafted to address participations in the debt in which a buyer purchases a contractual right to a borrower's payments to the seller and assumes the duty to fund the seller's funding obligations.[3] However, credit agreements do not address participations in detail and frequently do not address other derivative forms of debtholding, such as credit default swaps and total return swaps, at all.

c. *Tax Implications*

A waiver or modification of debt can have significant tax consequences for both issuer and creditor. Those consequences depend on whether the waiver or

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trading in the debtor's securities (but arguably not from trading its bank debt, as discussed further in Part IV.D.2.b of this outline).

[2] 15 U.S.C. § 77ppp(a).

[3] Participations are discussed further in Part IV.B.1.b of this outline.

modification constitutes a "significant modification" for tax purposes.[4] If so, then the old debt is treated as having been exchanged for new debt (even absent an actual exchange of old debt for new debt) in either a taxable or tax-free exchange. This actual or deemed exchange may result in the issuer recognizing cancellation of debt ("COD") income on the old debt, and the new debt being deemed to be issued with original issue discount ("OID").[5] This subject is discussed extensively in Part I.B.4.c.viii of this outline. If, on the other hand, there has been no significant modification, then the modification (even if there is an actual exchange of debt) is not a taxable event.

A change that occurs by operation of the terms of the debt instrument generally is not a modification.[6] A change is considered to occur by operation of the terms of the debt instrument if it occurs automatically (*e.g.*, a specified increase in the interest rate if the value of the collateral declines below a specified level). Thus, an increase in the interest rate that occurs automatically upon a breach of a covenant (*i.e.*, a default rate) should not be a modification.

A change that is a "modification" is, as a general rule, "significant" if the legal rights or obligations that are altered, and the degree to which they are altered, are "economically significant."[7] However, certain types of modifications, including changes to the interest rate and/or maturity date, changes in the subordination of the debt or the security underlying the debt, and changes in obligor, are tested for significance under more specific rules.[8] For example, a change to the pricing of a debt instrument may result in a significant modification if the yield on the instrument differs by more than a specified amount.[9]

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[4] *See* 26 C.F.R. § 1.1001-3.

[5] *See* 26 U.S.C. § 61(a)(12); *id.* § 1273(a).

[6] 26 C.F.R. § 1.1001-3(c)(1)(ii).

[7] 26 C.F.R. § 1.1001-3(e)(1). If more than one modification has been made to a debt instrument, the significance of the modifications is considered collectively, such that one or more modifications that on their own are not significant may, when considered together, be significant.

[8] 26 C.F.R. §§ 1.1001-3(e)(2), (3), (4), (5) and (6).

[9] A change in yield constitutes a significant modification if the yield of the modified debt differs from the yield on the unmodified debt (determined as of the date of the modification and taking into account any prior modification occurring in the last five years) by more than the greater of (a) 25 basis points or (b) 5% of the annual yield of the unmodified debt. 26 C.F.R. § 1.1001-3(e)(2)(ii); 26 C.F.R. § 1.1001-3(f)(3).

In the case of a significant modification of debt or an actual exchange of debt for debt or equity, the resulting COD income generally is measured by reference to the fair market value of the debt or equity for which the old debt is exchanged or deemed exchanged (except in the case of a debt modification or debt-for-debt exchange where the debt is not publicly traded for tax purposes, as explained below). If an issuer's debt is worth significantly less than par, the COD income may be considerable. However, in the case of a debt modification or debt-for-debt exchange, the COD income generally will be offset by future OID deductions.[10] Further, an issuer that is insolvent or in bankruptcy may be able to exclude all or a portion of the resulting COD income. These and other tax issues are explained in greater detail in Part I.B.4.c.viii of this outline.

3. Costs to Borrowers of Forbearance, Waiver, and Amendment

It is typical for creditors who agree to a waiver or an amendment to insist on effectively repricing the debt through a combination of fees, interest rate margin increases, and floors on index rates (such as LIBOR) in excess of the actual index rate.[11] Other typical requests include commitment reductions on revolving credit lines, additional collateral, paydowns, new caps on investments and dividends, new money from equity investments or junior debt (if feasible), and subordination or forgiveness of debt held by a controlling equityholder. For instance, in the wake of the recent decline of oil and gas prices, borrowers in the energy sector incurred such costs in order to amend and extend their loans, hoping to buy time until prices might rebound.

B. Out-of-Court Transactions

If a financially distressed company cannot restructure its debt with the cooperation of its lenders through forbearance, waiver or amendment agreements,

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[10] Certain rules, including section 163(j) of the Internal Revenue Code and the "applicable high-yield discount obligation" rules, may limit the issuer's ability to deduct OID. These rules are discussed in Part I.B.4.c.viii of this outline.

[11] Unsecured creditors are relatively more likely to take upfront fees in a situation of significant distress. Secured creditors, in contrast, will also seek a higher interest rate because, in the event of a subsequent bankruptcy, section 506(b) of the Bankruptcy Code will enable them to receive interest postpetition to the extent that they are oversecured—a benefit that unsecured creditors cannot obtain. However, the fees and pricing increases implemented in connection with a waiver or amendment may be limited by intercreditor agreements. In a typical formulation, first and second lienholders agree that neither will increase its interest rate, or take corresponding fees, in excess of an agreed level without the consent of the other.

then it may be forced to take other measures addressed in the remainder of this Part I. Most of the following actions involve a dilution or change in the equityholders' control of the distressed company, and thus provide opportunities for a potential investor to acquire interests in, assets from, or ownership of the distressed company.

Dealing with a company in this stage entails numerous risks for investors. For example, a restructuring could lead to changes in covenants or other contractual protections, and purchases of assets may later be challenged on fraudulent conveyance grounds. Additionally, if an exchange offer is contemplated, the tax implications must be carefully considered. This section highlights potential benefits and risks of dealing with a company on the verge of bankruptcy, as well as techniques to capture benefits and mitigate risk.

1. Sales of Assets Outside of Bankruptcy

A financially distressed company may attempt to sell assets or businesses for a variety of strategic reasons, including to raise cash or eliminate distractions to management from non-core businesses. While selling a portion of a distressed company is not an easy task, it may be the company's best—or only—option. The company's lenders may require it to market assets for sale or even complete a sale by a specified date in order to obtain needed amendments to its credit agreement. Conversely, credit agreements frequently restrict dispositions of assets not in the normal course of business, so lender consents may be required for the transaction. Either way, a distressed company's lenders will likely have a role. Prospective purchasers of assets from a distressed company should be aware, however, that such sales outside of bankruptcy entail significant risks.

a. *Fraudulent Transfer Risks*

An investor looking to purchase assets from a distressed company must consider and address the risk of fraudulent transfer claims. Under section 548 of the Bankruptcy Code, a company may avoid transfers it made or obligations it incurred prior to its bankruptcy filing date if it made the transfer or incurred the obligation within two years before the filing date "with actual intent to hinder, delay, or defraud" creditors.[12] In addition, a transfer or obligation made during that two-year period may be avoided as a "constructive" fraudulent transfer if the company received less than "reasonably equivalent value" in exchange for the

[12] 11 U.S.C. § 548(a)(1)(A).

transfer, and the company (a) was insolvent at the time of the transfer or became insolvent as a result of the transfer, (b) was engaged in, or about to engage in, a business or transaction for which any property remaining with the company was "unreasonably small capital," or (c) intended to incur, or believed that it would incur, debt that would be beyond its ability to pay as such debt matured.[13]

In addition to the Bankruptcy Code, most states have fraudulent transfer or fraudulent conveyance provisions of their own, which generally provide for recovery periods that are longer than the Bankruptcy Code's (either three or four years in most states, and six years in New York State).[14] In bankruptcy, a representative of the debtor generally can pursue any avoidance claims an unsecured creditor would have under state law.[15]

Although the purpose of a transaction may be to stabilize a distressed seller, there is a risk that a court looking back as long as six years before a bankruptcy filing date (often itself years earlier) could, with the benefit of 20/20 hindsight, find that the purchase price paid by the acquiror was less than "reasonably equivalent value" and, thus, invalidate the sale as a fraudulent conveyance. Sales by severely distressed companies are made under pressure and often involve troubled assets for which potential bidders are wary of overpaying. As a result, distressed sales carry a higher risk of being found to have been made with an intent to hinder, delay or defraud creditors, or for less than "reasonably equivalent value," by a seller found to have been insolvent at the time of sale.[16] For example, in *In re*

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[13] 11 U.S.C. § 548(a)(1)(B).

[14] The Uniform Fraudulent Transfer Act has been enacted by most states with the notable exception of New York (which still adheres to its predecessor, the Uniform Fraudulent Conveyance Act).

[15] *See* 11 U.S.C. § 544(b).

[16] As noted above, courts may also find that a constructive fraudulent transfer has occurred on the basis that the debtor was engaged in, or about to engage in, a business or transaction for which any property remaining with the company was "unreasonably small capital." 11 U.S.C. § 548(a)(1)(B). Recently, in *In re SemCrude, L.P.*, 648 F. App'x 205 (3d Cir. 2016), the U.S. Court of Appeals for the Third Circuit addressed the meaning of "unreasonably small capital" in the context of a constructive fraudulent transfer avoidance action. Affirming the decision of the district court, the Third Circuit held that a debtor can have unreasonably small capital even if it is solvent, and that a "reasonable foreseeability" standard should be applied in assessing whether capitalization is adequate. *See also In re Adelphia Commc'ns Corp.*, 652 F. App'x 19, 21 (2d Cir. 2016) (stating that "unreasonably small" capital test focuses on reasonable foreseeability and that the test is met if the debtor shows it had such minimal assets that insolvency was "inevitable in the foreseeable future").

Bridgeport Holdings, Inc., the debtor conducted what the court termed a "fire sale" of a substantial portion of its assets just one day before filing bankruptcy, and the purchaser ultimately settled a fraudulent transfer action brought by the Trustee for $25 million (thereby nearly doubling the initial purchase price of $28 million).[17]

In the energy space, fraudulent transfer risks may exist for investors who purchase so-called "fractional interests" from distressed oil and gas companies. Many oil and gas companies enter into term leases with mineral estate owners for the exclusive right to drill and produce hydrocarbons; the leased portion of a mineral estate is the "working interest," from which a variety of "fractional interests" can be carved out and sold to investors to raise funds. Common types of fractional interests include "ORRIs" (overriding royalty interests) and "NPIs" (net profit interests). The decline in oil and gas prices in recent years provided opportunities for investors to purchase fractional interests inexpensively. Such a transaction may be subject to constructive fraudulent transfer claims if the company later files for bankruptcy, on the grounds that the company was insolvent when it made distributions to the investor and received less than reasonably equivalent value.[18]

A conveyance might be deemed fraudulent not only if it transfers assets outside of a corporate group, but also if it transfers assets within a corporate group to the detriment of certain creditors. The *ASARCO* case is an important example of this.[19] ASARCO sold its "crown jewel" asset—a controlling interest in a

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[17] *Bridgeport Holdings, Inc. Liquidating Tr.* v. *Boyer (In re Bridgeport Holdings, Inc.)*, 388 B.R. 548, 553-58 (Bankr. D. Del. 2008). *In re Bridgeport* also presents important lessons in corporate governance when dealing with severely distressed companies. The bankruptcy court found that the directors and officers of Bridgeport, as well as an outside restructuring advisor who had been appointed as chief operating officer, breached their fiduciary duties of loyalty and care in connection with the sale. *Id.*

[18] For example, in *In re ATP Oil & Gas Corp.*, discussed further in Part I.B.3.b.iv of this outline, the Official Committee of Unsecured Creditors filed a motion requesting authority to bring fraudulent transfer actions against one of ATP's investors, alleging that ATP did not receive reasonably equivalent value in exchange for certain ORRIs. No. 12-36187 (Bankr. S.D. Tex. Oct. 31, 2012), ECF No. 748. After the case was converted to a chapter 7 liquidation, the trustee for ATP pursued fraudulent transfer claims arising out of the sale of NPIs and ORRIs against ATP's former officers and directors. Though the court dismissed the claims, it did so for lack of factual support rather than as a rejection of the underlying fraudulent transfer theory. *Tow* v. *Bulmahn*, 2016 WL 1722246, at *27 (E.D. La. Apr. 29, 2016). Accordingly, whether these types of transactions are subject to challenge on fraudulent transfer grounds remains an open issue.

[19] *ASARCO LLC* v. *Ams. Mining Corp.*, 396 B.R. 278 (S.D. Tex. 2008).

Peruvian mining concern, SPCC—to its parent and sole shareholder, AMC, at a time when ASARCO was in financial distress. Under the control of AMC, as well as AMC's parent, Grupo, ASARCO used the proceeds of the sale to pay down a $450 million revolving credit facility that Grupo had guaranteed and in which it held a participation interest. ASARCO also used an additional $50 million to pay bond creditors whose consent to the transaction was required, allowing those creditors to receive a par recovery even though the bonds were trading at a substantial discount. A federal district court in Texas found that this transaction was entered into with actual intent to hinder, delay, or defraud ASARCO's other creditors because it was designed to allow the debtor's shareholder to retain possession of a valuable asset while at the same time having the effect of worsening ASARCO's "liquidity crisis."[20] Even though the court found that AMC had paid reasonably equivalent value for the SPCC stock, it ruled that the transaction should be unwound and the SPCC stock returned to ASARCO.[21]

A related risk arises when a parent company spins off a weak subsidiary, potentially in preparation for a sale of some or all of itself. While such a transaction may strengthen the parent and make it more attractive to buyers, the pre-sale transfer could constitute a fraudulent conveyance. The *Tronox* case illustrates this risk.[22] In 2006, Kerr-McGee Corporation transferred its valuable oil and gas exploration and production business into a new wholly owned subsidiary ("New Kerr-McGee"), leaving behind its smaller chemical business and significant legacy environmental and tort liabilities. The remaining business was renamed "Tronox" and spun off. Free of the legacy liabilities, New Kerr-McGee then sold itself to Anadarko Petroleum for $18.4 billion. Tronox filed for bankruptcy three years after the spin-off and creditors alleged that the transfer of the exploration business to New Kerr-McGee was a fraudulent conveyance.

The court in *Tronox* found that the transfer of the exploration business and the spin-off of Tronox together constituted a fraudulent conveyance made with actual intent to hinder, delay or defraud creditors because "[t]he obvious consequence" of freeing substantially all of Kerr-McGee Corporation's assets from its significant legacy liabilities "was that the legacy creditors would not be able to claim against [those assets], and with a minimal asset base against which to

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[20] *Id.* at 371-79, 388-93.

[21] *Id.* at 364.

[22] *In re Tronox Inc.*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013).

recover in the future, would accordingly be 'hindered or delayed' as the direct consequence of the scheme."[23] The court also found the transactions to be constructive fraudulent conveyances even though Tronox was able to issue debt at the time of the spin-off and survived for three years thereafter. While acknowledging that such market evidence is generally probative of solvency, the court found it unpersuasive because the company's significant environmental and tort liabilities were not adequately disclosed in public financial statements. After the bankruptcy court's decision, the parties entered into a settlement under which New Kerr-McGee paid $5.15 billion plus interest to Tronox's environmental and tort creditors.

Tronox represents an important warning about the risks of disproportionately allocating legacy liabilities to an entity that cannot support them. In structuring a transaction, in addition to ensuring that an entity assuming significant liabilities can service them, several other strategies are helpful in mitigating the risks arising from a sale or spin-off of distressed assets, although none can eliminate the risks completely. To start, the parties to a transaction should ensure that there is a record of an arm's-length disposition process conducted in good faith and resulting in reasonable terms. As part of that process, it may be helpful for a distressed company and/or its counterparty to seek a solvency, capital adequacy/surplus or valuation opinion, or some combination thereof, from a third-party expert. In a significant asset sale or other transfer that might be challenged after the fact as having undermined the solvency of the company or to have been made for less than reasonably equivalent value, such an opinion may be useful in defending the transaction against fraudulent conveyance claims.[24] It should be kept in mind, however, that courts do not always find such solvency opinions dispositive, particularly where they do not adequately account for contingent liabilities. In *Tronox*, for example, the court noted that "there [was] no evidence that [the firm that gave the solvency opinion] was even aware of the importance

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[23] *Tronox*, 503 B.R. at 280; *cf. U.S. Bank Nat'l Ass'n* v. *Verizon Commc'ns, Inc.*, 761 F.3d 409, 434-36 (5th Cir. 2014) (finding Verizon's 2006 spin-off of Idearc, Inc. was neither constructive nor actual-intent fraudulent conveyance because Idearc was solvent at time of spin-off and there was insufficient evidence of fraudulent intent).

[24] In addition, sections 141(e) and 172 of the Delaware General Corporation Law allow the directors of any company, including one that is in financial distress, to rely in good faith on reports of the company's officers or experts selected with reasonable care as to matters reasonably believed to be within the professional or expert competence of such persons, and a solvency opinion may help to establish that the directors approved the transaction in good faith in accordance with their fiduciary duties.

of the legacy liabilities to Tronox's solvency."[25] The risk that an expert opinion rendered long after-the-fact can unravel even a well-planned transaction if the company ultimately fails often compels asset purchasers to condition the purchase on approval from a bankruptcy court, which insulates the purchaser from a subsequent contention that the purchaser underpaid.[26]

Despite its importance to the fraudulent conveyance analysis, the appropriate measure of "reasonably equivalent value" is not specified in the Bankruptcy Code, and the definition of solvency in the applicable statutes is likewise less than crystal clear.[27] This lack of certainty—combined with the ready availability of experts able to make plausible cases for a wide range of values, and the tempting inference that, because a company is insolvent now, it was probably insolvent at the time the challenged transaction occurred—tends to work to the advantage of parties challenging transactions as fraudulent conveyances. Prior to *Tronox*, courts had become increasingly receptive to looking to contemporaneous market evidence of value as a more objective measure of solvency at the time of the challenged transaction. In *VFB LLC* v. *Campbell Soup Co*., for example, the U.S. Court of Appeals for the Third Circuit held that the market capitalization of a publicly traded entity that had been spun off from its parent was a proper measure of its value, noting that market capitalization reflects all publicly available information at the time of measurement and that "[a]bsent some reason to distrust it, the market price is 'a more reliable measure of the stock's value than the subjective estimates of one or two expert witnesses.'"[28] By contrast, in *Tronox*, the court suggested that while the market evidence relied upon in *Campbell* was useful for a "typical case," it was unavailing for a case involving significant

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[25] *Tronox*, 503 B.R. at 287.

[26] Part III of this outline describes the various methods by which a distressed company and would-be acquiror can use the Bankruptcy Code to their advantage in shaping a sale of part or all of a company.

[27] The Bankruptcy Code defines "insolvent" (for entities other than partnerships and municipalities) as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a *fair valuation*." 11 U.S.C. § 101(32) (emphasis added). The meaning of "fair valuation" has been left to the courts.

[28] 482 F.3d 624, 633 (3d Cir. 2007) (quoting *In re Prince*, 85 F.3d 314, 320 (7th Cir. 1996)); *see also Statutory Comm. of Unsecured Creditors ex rel. Iridium Operating LLC* v. *Motorola, Inc.* (*In re Iridium Operating LLC)*, 373 B.R. 283, 291 (Bankr. S.D.N.Y. 2007) (endorsing the Third Circuit's reasoning in *VFB*); *U.S. Bank Nat'l Ass'n* v. *Verizon Commc'ns, Inc.*, 2013 WL 230329 (N.D. Tex. Jan. 22, 2013) (finding that Idearc, Inc. was solvent at time of 2006 spin-off from Verizon on basis of market evidence of value), *aff'd*, 761 F.3d 409 (5th Cir. 2014).

environmental and tort liabilities in light of the limitations of GAAP accounting for such liabilities. The *Tronox* court thus found that in such cases, "the market as a whole, no matter how efficient or inefficient, cannot be relied on to determine solvency or insolvency."[29] Accordingly, while investors seeking to purchase assets from a distressed company should certainly consider the trading prices of the company's debt and equity and other contemporaneous market evidence of value, favorable market evidence may not guarantee that a company will later be found to have been solvent at the time of the transfer, especially where the company faces significant environmental or tort liabilities or other obligations that may not be fully reflected on the balance sheet.

b. *Other Risks*

If a company files for bankruptcy protection after the signing but prior to the closing of an asset sale transaction, the prospective purchaser is subject to risk that the now-bankrupt company will exercise its rights under section 365 of the Bankruptcy Code to reject the sale agreement, attempt to renegotiate the terms of the sale by threatening rejection, or "cherry pick" among the different transaction agreements by rejecting some and assuming others.[30] Upon rejection, the company will have no further obligations to perform under the agreement and the purchaser generally will have an unsecured prepetition claim for any damages it suffers.

Similar risks may exist when a transaction closes and the company then files for bankruptcy. For example, the company will have gained the ability to reject undesirable contracts, such as a post-closing transition agreement, while the buyer may be left with relatively worthless representations, warranties, and indemnities, since any claims for breach against a bankrupt company will be prepetition unsecured claims, which are often paid far less than 100 cents on the dollar. In addition, payments received by the purchaser post-closing but pre-filing, including true-up payments or purchase price adjustments, may be subject to avoidance by the company as preferences, which are explained in Part I.B.3.b.i of this outline.

Even if the company does not later file for bankruptcy protection, it may become unable to provide transition services, satisfy indemnification requirements, or fulfill other ongoing obligations relating to the sale. The investor should also be

[29] 503 B.R. at 302-03.

[30] *See* Part III.B.8 (discussing executory contracts).

mindful of the impact the company's financial distress and deteriorating creditworthiness may have on its relationships with key customers, suppliers, landlords, and other business partners.

There are several measures that an investor may choose to negotiate with a distressed company that can alleviate these concerns to some extent. For example, transaction documents can be drafted to include language evidencing the parties' intent to integrate the agreements and thereby reduce the company's ability to "cherry pick" the more favorable transaction agreements. Other potential protections for a purchaser include the granting of a lien on other assets of a company to secure indemnification, damages, and other claims, or structuring the transaction to include a holdback note or escrow account.

Despite these protective measures, a purchaser may be reluctant to enter into an agreement with the company if there is considerable uncertainty regarding the company's financial condition and future viability. As an alternative, a purchaser may prefer to incur the delay, auction-related deal risk, and additional expense associated with the bankruptcy process and, accordingly, insist that the company file for bankruptcy and condition the purchase on court approval, which alleviates most of these risks and may afford the purchaser certain additional benefits, as discussed in Part III.A of this outline.

2. Sales of Securities by Distressed Companies

A company in distress may seek new capital to reduce debt, cover operating losses, or otherwise shore up its capital structure in order to get through a difficult financial period. Frequently, however, distressed companies find that their ability to raise additional debt or equity capital is limited by factors that are outside their control, such as restrictions on issuance contained in the terms of the company's existing debt, unfavorable credit or equity markets, the extent of the company's then-current leverage, regulatory restrictions, or similar factors. Some companies have been able to successfully navigate these limitations and raise capital by means of a rights offering or a private investment in public equity (a "PIPE") transaction.

a. *Rights Offerings*

A rights offering can enable a company to issue equity even when faced with unfavorable capital markets by offering all existing shareholders the opportunity to participate in the capital raise *pro rata*. In a typical transaction, the issuer will distribute to its shareholders the right, for a limited period of time (typically 30 to 45 days), to subscribe for additional shares at a subscription price that is at or

below the market price of its outstanding shares at the close of trading immediately before the offering. Because the rights offering is made to existing shareholders, the company does not need to engage underwriters; this may enable the company to raise equity even when a traditional underwritten offering is not an option. In addition, by allowing existing shareholders to participate in the offering, a rights offering can reduce the "sting" of issuing stock at a below-market price. To help ensure the success of the rights offering, issuers often make the rights tradable, so that existing shareholders who do not wish to increase the size of their investment can sell the rights to third parties, and obtain a standby commitment (or a "backstop") from one or more investors to purchase any unsubscribed shares.

b. *PIPEs*

Another capital-raising option that may be appropriate for a distressed company is a PIPE investment, which involves a privately negotiated purchase of newly issued equity in a public company. While each PIPE investment is unique and individually negotiated, an investor typically purchases new securities from the issuer at a discount to market. The new securities could be common stock, or they could be other securities, such as preferred stock or unsecured notes, that are convertible into common stock. The investor may also receive governance rights, such as a right to designate one or more members of the issuer's board of directors. Securities issued in privately negotiated PIPE investments are not typically registered with the Securities and Exchange Commission (the "SEC") at issuance, so issuers will often enter into a registration rights agreement committing to register the securities or any common stock into which such securities can be converted within a specified period of time. In some cases, particularly when the issuer already has an effective shelf registration statement on file with the SEC, it may issue registered securities in a private placement (a "registered direct offering"). The distressed issuer should also consider whether the contemplated PIPE investment requires shareholder approval and, if so, the various adverse consequences that delay attendant to obtaining such approval may have on its survival. Counsel should be consulted early on to determine whether an exception exists or the transaction can be structured in such a way as to avoid the need for a shareholder vote.

3. Debt Repurchases

Whether due to broad market conditions or firm- or industry-specific distress, a company's debt may trade below par. This pricing presents an opportunity for a debt issuer to de-lever by repurchasing some or all of its own debt. There are two primary ways to repurchase debt: for cash, if the company has sufficient

liquidity, or through an exchange offer (discussed in Part I.B.4 of this outline). There are several issues involved in repurchasing debt, no matter the method of repurchase or the premium paid.

a. *Issues in Bank Debt Repurchases*

(i) *Pro Rata* Sharing Provisions and Eligible Assignees

Syndicated credit agreements generally contain a clause requiring *pro rata* sharing of payments. Under these provisions, any payment on loans under the credit agreement, no matter how obtained, must be allocated ratably among all lenders based on the proportion of the overall loans held by each lender. Originally, *pro rata* sharing clauses were included in credit agreements to address the practice of lenders exercising their rights of setoff against the borrower's bank accounts, thereby reducing the assets available to satisfy the claims of the other lenders and causing different recoveries among members of the same lender group.

While *pro rata* sharing clauses in credit agreements are generally thought not to require sharing of the proceeds obtained from the sale of loans to third parties (even though they are sometimes drafted broadly enough to capture such "payments"), repurchases by the borrower and its affiliates are more problematic, as a sale of a loan back to the borrower is economically identical to a repayment of that loan. This economic reality may lead to a dispute with other lenders in the group about whether the *pro rata* sharing clause applies, and the prospect of such a dispute may itself serve as a barrier to the repurchase. Many borrowers and their sponsors confronted this issue in 2008 and 2009 when repurchase opportunities were everywhere but loan documentation often required amendments of the type described below in order to take advantage of such opportunities. When a credit agreement clearly prohibits sales of the loans back to the borrower unless the proceeds are shared *pro rata* among all lenders, an amendment (typically requiring 100% lender consent) is required to make discounted repurchases possible. Meanwhile, credit agreements that exclude repurchase by the borrower from the *pro rata* sharing clause may nevertheless contain a separate prohibition on assignments of debt to the borrower and its subsidiaries, again requiring an amendment (in this case, typically requiring only majority consent) to make discounted repurchases possible.

(ii) Dutch Auction and Open Market Repurchases; Sponsor Purchases

During the 2008 financial crisis, the desire of lenders to obtain liquidity from any source possible led to a robust practice of amending the *pro rata* sharing and assignee provisions described above to specifically allow buybacks/purchases of debt by borrowers and their affiliates on specified terms. Typically, (i) borrowers would be permitted to spend up to some fixed amount making open market repurchases of their own loans and to spend significantly more on repurchases offered to all lenders pursuant to "Dutch auction" procedures;[31] and (ii) affiliates/sponsors would be permitted to buy up to a set percentage of the aggregate loan obligations in the open market, subject to certain conditions, including a waiver of the right to vote the purchased debt.

The genie having left the bottle, these seeming financial crisis band-aids are now common throughout the market, and have been baked into original loan documentation in various forms, especially in connection with private equity sponsored deals.

b. *Other Repurchase Considerations*

(i) Avoidable Preferences

Although depressed pricing may present a borrower with an attractive opportunity to repurchase its debt at a discount to par, if the source of that depressed pricing is the borrower's own poor performance or prospects, the company and its creditors should be mindful that the repurchase may prove to be an avoidable preference if the company files for bankruptcy soon thereafter. Under section 547(b) of the Bankruptcy Code, a transfer to a creditor on account of an antecedent debt is presumptively preferential if it was made when the borrower was insolvent and within 90 days of a bankruptcy filing (one year for transfers to insiders) and it leaves the creditor better off than if the transfer had not been made.[32] Such

[31] In a typical Dutch auction for bank debt, the borrower offers to buy debt of up to a specified face amount at a discount to par of not less than a specified percentage. Each lender then submits a bid whereby it commits to sell to the borrower a set amount of loans at a specified discount to par. The clearing price is the greatest discount to par at which the borrower has received enough bids to sell the entirety of the proposed face amount.

[32] 11 U.S.C. § 547(b).

preferential transfers are "avoidable," meaning they can be unwound in the borrower's bankruptcy case.

(ii) Corporate Opportunity Doctrine

Sponsors and affiliates face a special set of issues when repurchasing debt. Where an affiliate or insider of a company purchases debt of the company at a discount, there may be some risk that the purchase could be challenged later as an improper usurpation of a corporate opportunity. The "corporate opportunity" doctrine generally provides that a person with a fiduciary relationship to a company may not pursue an opportunity that is within the company's line of business if the company has an interest or expectancy in the opportunity and is financially able to exploit the opportunity, unless the person first presents the opportunity to the company and obtains its informed approval to pursue the opportunity.[33] Sponsors and affiliates should consider protecting themselves from potential liability by disclosing to the company their intention to repurchase the company's debt in order to give the company the opportunity to repurchase the debt instead.

The benefits of such disclosure are well illustrated by the clean bill of health that the private equity firm Apax Partners obtained for its purchase of some $521 million of the debt of its portfolio company Cengage Learning, Inc. Apax purchased the debt intending to subordinate it in exchange for extensions on the maturities of various Cengage credit facilities. The negotiations failed and Cengage filed for bankruptcy. An independent director was appointed to the board and commissioned a special investigation assessing potential claims against Apax. Because Apax had first disclosed its intent to purchase the debt to Cengage's board of directors and the board of directors had passed a resolution acknowledging that Cengage had been afforded the opportunity to repurchase the debt on its own behalf, the investigation concluded that a claim against Apax under the corporate opportunity doctrine would be unlikely to succeed.[34]

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[33] The origin of the corporate opportunity doctrine generally is attributed to *Guth* v. *Loft, Inc.*, 5 A.2d 503 (Del. 1939), which first established the doctrine as a distinct branch of fiduciary duty law. *See also* William Savitt, *A New New Look at Corporate Opportunities* (Columbia Law Sch. Ctr. L. & Econ. Studies, Working Paper No. 235, 2003), http://ssrn.com/abstract=446960.

[34] *See* Report of Richard D. Feintuch, Independent Director of Cengage Learnings GP I LLC, at 49-52, *In re Cengage Learning, Inc.*, No. 13-44106 (Bankr. E.D.N.Y. Oct. 3, 2013), ECF No. 553-1.

(iii) Equitable Subordination

Another risk for parties that buy debt in an issuer with which they have a relationship is the potential for the nature or priority of their debt to be modified by a bankruptcy court. Section 510(c) of the Bankruptcy Code permits a bankruptcy court to "equitably subordinate" all or part of a creditor's claim to the claims of other creditors in order to remedy harm suffered as a result of inequitable conduct. Debt purchased by an affiliate, fiduciary, or insider of an issuer (including a private equity sponsor) may be subject to claims by creditors that such debt should be "equitably subordinated" in the event the company files bankruptcy, on grounds that such parties controlled the borrower and are accountable either for the insolvency or for some other allegedly culpable action.

For example, the special investigation in the *Cengage* bankruptcy case (described above) considered whether Apax's purchase of Cengage debt involved fraud, illegality, or breach of fiduciary duty; whether Cengage was undercapitalized or was an "alter ego" or "mere instrumentality" of Apax; whether Apax had attempted to depress the market price of the debt; and whether Apax had used the purchases as a means to control Cengage's chapter 11 restructuring. The court ultimately concluded there was no basis for equitably subordinating Apax's claims.[35]

(iv) Recharacterization of Debt as Equity

Along with the risk of equitable subordination, there is a risk that debt of a troubled firm purchased by a sponsor, parent, affiliate, insider or fiduciary of such firm may be recharacterized by a bankruptcy court as equity rather than debt. Because such persons have the ability to denominate advances to the firm as either "debt" or "equity," bankruptcy courts will look behind the name assigned to a particular infusion of funds and determine whether the advance should, in substance, be treated as equity in a bankruptcy case.[36]

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[35] *Id.* at 81-86.

[36] *See, e.g.*, *In re Lyondell Chem. Co.*, 544 B.R. 75, 93 (Bankr. S.D.N.Y. 2016) (bankruptcy courts have power to recharacterize debt as equity when warranted by facts); *In re Fitness Holdings Int'l, Inc.*, 714 F.3d 1141, 1148 (9th Cir. 2013) (court has power to recharacterize debt as equity in context of fraudulent transfer claim); *In re SubMicron Sys. Corp.*, 432 F.3d 448 (3d Cir. 2006) (recognizing power to recharacterize, but affirming refusal to do so); *In re Autostyle*, 269 F.3d 726 (6th Cir. 2001); *In re Eternal Enters., Inc.*, 557 B.R. 277, 286-93 (Bankr. D. Conn. 2016) (recharacterizing purported loan made by insiders of family business as an equity contribution). A minority of courts have held that bankruptcy courts lack power to recharacterize as equity what

If a court determines that an advance is equity rather than debt, the holder will lose the ability to be paid on that debt along with other creditors. The holder may also be exposed to claims that prior payments received on account of the debt should be treated as dividends that can be recovered as fraudulent transfers.

Recharacterization is within the equitable discretion of the bankruptcy court, and the decision to impose it is highly fact dependent. Courts may consider, among other factors, the labels given to the debt; the presence or absence of a fixed maturity date, interest rate, and schedule of payments; whether the borrower was adequately capitalized; any identity of interest between the borrower and the equity owner; whether the loan is secured; and the borrower's ability at the time the putative debt was incurred to obtain financing from non-insider lending sources. The gist of the analysis is "typically a commonsense conclusion that the party infusing funds does so as a banker (the party expects to be repaid with interest no matter the borrower's fortunes; therefore, the funds are debt) or as an investor (the funds infused are repaid based on the borrower's fortunes; hence, they are equity)."[37] However, the threat of recharacterization has the paradoxical and unfortunate effect of deterring insiders from making loans to save their failing businesses when non-insiders are unwilling to do so, because the inability to obtain loans from a third-party financing source is a factor weighing in favor of recharacterizing such loans as equity.

Recharacterization related to property interests has come into play in bankruptcy cases involving oil and gas companies, which have addressed whether transactions involving fractional oil and gas interests (*e.g.*, ORRIs and NPIs), discussed in Part I.B.1 of this outline, effectuate true property conveyances or are simply disguised loans. In *In re ATP Oil & Gas Corp.*,[38] the Bankruptcy Court for the Southern District of Texas found that the fractional interests at issue—term

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has been labeled debt, but at present, this represents neither the majority view nor the trend in the cases. *See, e.g.*, *In re Airadigm Commc'ns, Inc.*, 376 B.R. 903, 911 (Bankr. W.D. Wis. 2007), *aff'd*, 392 B.R. 392 (W.D. Wis. 2008), *aff'd in part, rev'd in part*, 616 F.3d 642, 657 (7th Cir. 2010) (noting that "the overwhelming weight of authority supports the proposition that bankruptcy courts act within their equitable powers when they recharacterize loans as infusions of equity").

[37] *See In re SubMicron*, 432 F.3d at 456; *accord In re Autostyle*, 269 F.3d at 748-53.

[38] 2014 WL 61408, at *16 (Bankr. S.D. Tex. Jan. 6, 2014).

ORRIs (overriding royalty interests)—could be recharacterized as debt, despite their long-standing treatment as real property transfers under Texas law.[39]

A sponsor, parent, affiliate, insider, or fiduciary considering purchasing the debt of a distressed firm should assess the risk of recharacterization carefully. Such an analysis may be particularly important for private equity firms: purchases by a private equity firm of its portfolio company's debt may be less risky if the debt is purchased in the secondary market, rather than originated by making a direct extension of credit to the issuer. In addition, in "rescue capital" transactions involving the issuance of both debt and equity where the investor ultimately obtains control, the risk of recharacterization of the debt portion of an investment may be heightened, given the intent to control manifested by the equity component of the transaction.

(v) Insider Trading

Bonds are generally considered to be securities and therefore subject to the federal securities laws and prohibitions on insider trading. A company considering a debt buyback therefore must consider the insider trading prohibition imposed by Rule 10b-5 of the Exchange Act.[40] Consequently, companies frequently consider limiting bond repurchases to specified window periods (similar to those employed for trading in equity securities), such as a short period after the announcement of quarterly results, and avoiding purchases during sensitive periods (such as near the end of a quarter until earnings are announced or when the company is seriously pursuing a significant transaction). Even during window periods, companies engaging in repurchases may need to determine whether they (or the person who authorizes the trade)[41] are in possession of material nonpublic information.[42]

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[39] *Id.* at *1 ("an ORRI that is virtually certain to be satisfied in full from production is the economic equivalent of an 'obligation to repay,'" *i.e.*, an unsecured loan, so that "economic substance" of transaction trumped formal designation as real property transfer).

[40] Case law applying Rule 10b-5 in the context of debt securities is limited, and at least one federal district court has held that a Rule 10b-5 claim is not available to convertible noteholders because the issuer does not owe them a fiduciary or other analogous duty. *See Alexandra Glob. Master Fund, Ltd.* v. *IKON Office Sols., Inc.*, 2007 WL 2077153 (S.D.N.Y. July 20, 2007).

[41] Rule 10b5-1(c)(2) promulgated under the Exchange Act provides an affirmative defense to a claim that a purchase or sale of securities was made "on the basis of" material nonpublic information if "the individual making the investment decision on behalf of the person to purchase or sell the securities was not aware of the information" and "the person had implemented

Interests in bank debt typically have not been considered to be securities for purposes of the federal securities laws,[43] but companies buying their own debt could still face claims for wrongdoing, such as common law fraud.

(vi) Tax Considerations

Issuers that are considering repurchasing their debt (or having an affiliate purchase their debt in the market) should be aware that such acquisitions, if made at a discount, generally will give rise to COD income.[44] This topic and other considerations are discussed in greater detail in the context of exchange offers in Part I.B.4.c.viii.

4. Exchange Offers

A financially troubled company may attempt to restructure its obligations out of court by offering to exchange one type of securities or obligations for another. Such transactions include debt-for-debt exchanges, debt-for-equity swaps, and hybrids where exchanging creditors receive a combination of new debt and stock or warrants.

An exchange offer gives a financially troubled company the chance to de-lever and avoid bankruptcy. It gives existing creditors the chance to improve their position relative to other creditors or gain control of the company via voting stock or contractual covenants. It also creates a risk for existing creditors who choose not to exchange that the value of their debt will decline precipitously. Non-exchanging creditors are also at risk that their debt documents will be amended

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reasonable policies and procedures, taking into consideration the nature of the person's business, to ensure that individuals making investment decisions would not violate the laws prohibiting trading on the basis of material nonpublic information." The SEC has indicated that this defense is available to an issuer of securities for a repurchase plan. *See* SEC Compliance and Disclosure Interpretations (Exchange Act Rules), Question 120.25 (Nov. 7, 2018), www.sec.gov/divisions/corpfin/guidance/exchangeactrules-interps.htm.

[42] A question to consider, and about which counsel should be consulted, is whether the set of information that is material to debtholders differs from that which is material to equityholders.

[43] *See Banco Español de Credito* v. *Sec. Pac. Nat'l Bank*, 973 F.2d 51, 55-56 (2d Cir. 1992) (widely cited case holding that a loan participation agreement among sophisticated financial institutions did not generate covered "securities").

[44] 26 U.S.C. § 61(a)(12); 26 U.S.C. § 108(e)(4).

via "exit consents" solicited from participating creditors to remove protective covenants.

a. *Exit Consents*

Exchange offers are often coupled with consent solicitations seeking consents from the exchanging creditors to amend the indenture or other documents governing the debt to be exchanged. These are referred to as "exit consents" because the consenting creditors are also "exiting" the investment in connection with the exchange. Because indentures typically require only majority approval for most amendments, consent solicitations encourage participation in exchange offers by presenting holders with the choice to either exchange or else retain securities that will, if the offer is successful, be stripped of covenants, change-of-control rights, and other protective provisions.[45]

The Trust Indenture Act (the "TIA"), which applies to all bonds issued in registered offerings,[46] imposes an important but narrow restriction on exit consents. Specifically, section 316(b) of the TIA provides that the right of a holder to receive payment "shall not be impaired or affected without the consent of such holder."[47] In *Marblegate Asset Management, LLC* v. *Education Management Corporation*, the U.S. Court of Appeals for the Second Circuit issued an important decision in 2017 clarifying that section 316(b) of the TIA prohibits only formal amendments to an indenture's "core payment terms"—*i.e.*,

[45] Amendments to the terms of an existing security may, under certain circumstances, result in the issuance of a new security requiring registration (or application for an exemption) under the Securities Act of 1933 (the "Securities Act") or qualification of the resulting indenture under the TIA. *See* Andrew R. Brownstein & Mitchell S. Presser, *Tendering for Debt: Structuring, Tactical and Legal Issues*, *in* RESTRUCTURING THE CORPORATE PRACTICE: FROM BUYOUTS TO BAILOUTS, SECOND ANNUAL SEMINAR (Mar. 1991). Although the SEC frequently has granted no-action relief in this context, issuers should take care to consider this issue prior to undertaking a consent solicitation that will result in significant alterations to the terms of the existing security. In at least one instance, the SEC declined to grant relief to an issuer seeking to extend the maturity date of a debenture, reasoning that it "would constitute an 'offer to sell' and 'sale' of a new security within the meaning of Section 2(3) of the 1933 Act, and Section 303(2) of the Trust Indenture Act of 1939." Allied-Carson Corp., SEC No-Action Letter, 1976 WL 10614 (Mar. 12, 1976).

[46] Although they are not technically subject to the TIA, bonds issued in private transactions without registration rights ("144-A for-life deals") may, as a practical matter, face the same issue. The indentures governing 144A bonds typically contain a provision similar if not identical to section 316(b) of the TIA, which courts may interpret the same way.

[47] 15 U.S.C. § 77ppp(b).

the amount owed and the date of maturity—but does not stand in the way of other nonconsensual amendments or transactions that might impact a distressed issuer's ability to repay its bonds, such as the release of a parent guarantee.[48] In so holding, the Second Circuit reversed the controversial decision of the district court, which had held that section 316(b) protects both a bondholder's *legal* right to sue for payment and its *practical* right to receive payment.[49] Notably, the district court's ruling had resulted in a wave of lawsuits brought under the TIA challenging transactions—including exchange offers and consent solicitations—that impacted issuers' ability to pay bondholders.[50] *Marblegate* brought an end to such suits, reinstating the traditional view that section 316(b) of the TIA provides only limited protection to noteholders by prohibiting formal modifications of payment terms or the right to sue.[51]

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[48] *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.*, 846 F.3d 1, 7 (2d Cir. 2017). The *Marblegate* case stemmed from efforts by Education Management Corp. ("EDMC") to deal with financial distress in 2014. As a for-profit higher education company, EDMC could not file for bankruptcy without facing automatic termination of its federal funding, so it instead pursued an aggressive out-of-court restructuring of roughly $1.3 billion of secured debt and $217 million of unsecured notes issued by an EDMC subsidiary. The proposal put forward by EDMC (with the support of its secured lenders) presented unsecured noteholders with two options: exchange their debt for equity or retain their notes. If any noteholders chose to retain their notes, the secured lenders would exercise their contractual rights to foreclose on the issuer's assets and release a guarantee of the notes by the issuer's parent company—rights both contemplated by the indenture, which remained unaltered. In essence, noteholders were forced to choose between retaining their nominal right to payment on their notes against an empty shell, or consenting to the transaction by converting their notes to equity in the parent. Marblegate Asset Management, LLC ("MAM"), which held $14 million of the unsecured notes, was the only party to reject the plan, forcing the company to attempt to implement the backup transaction. MAM objected to EDMC's restructuring, and litigation ensued, resulting in the district court's (now reversed) decision that an out-of-court restructuring involving the elimination of a parent guarantee and a significant asset transfer is impermissible under section 316(b) of the TIA because it would impair the nonconsenting noteholders' right to receive payment as a practical matter.

[49] *Marblegate Asset Mgmt., LLC* v. *Educ. Mgmt. Corp.*, 111 F. Supp. 3d 542, 546-54 (S.D.N.Y. 2015).

[50] *See generally* Harald Halbhuber, *Debt Restructurings and the Trust Indenture Act*, 25 AM. BANKR. INST. L. REV. 1 (2016).

[51] *See also Waxman* v. *Cliffs Nat. Res. Inc.*, 222 F. Supp. 3d 281 (S.D.N.Y. Dec. 6, 2016) (dismissing complaint that alleged that a debt-for-debt exchange offered only to institutional investors and non-U.S. persons, with no related consent solicitation, violated TIA section 316(b) because the facts alleged did not implicate the type of conduct that the TIA was designed to prevent).

b. *Stapled Prepacks*

A distressed company may pair an exchange offer and consent solicitation with a solicitation of acceptances for a prepackaged plan of reorganization pursuant to section 1126(b) of the Bankruptcy Code. This is sometimes referred to as a "stapled prepack." In a stapled prepack, an out-of-court restructuring is the company's desired outcome. But if the exchange consideration, combined with the threats of bankruptcy or stripped covenants, does not procure the necessary consents, then the votes collected in the out-of-court solicitation can be used in a bankruptcy case to bind all creditors to a substantially similar chapter 11 plan of reorganization, where acceptance of the plan by an impaired class requires only two-thirds by dollar amount, and a majority in number, of the claims that vote in that class—far less than the unanimous or near unanimous approval that would be needed for an out-of-court exchange affecting material economic rights.[52]

By way of example, in 2013, CEVA Logistics offered to exchange common and preferred stock for its second-lien notes and certain unsecured debt while soliciting support for a prepackaged plan. The exchange offer was successful, and the company was able to complete its restructuring out of court.[53] By contrast, also in 2013, Central European Distribution Corporation, one of Russia's largest vodka distributors, failed to garner the support needed to restructure certain of its outstanding notes via an out-of-court exchange offer; however, it promptly confirmed a prepackaged chapter 11 plan that was attached to the failed exchange offer.[54] In June 2015, gunmaker Colt Defense LLC filed for chapter 11 after conducting an exchange offer with a stapled prepack that failed to garner the necessary votes for either alternative, necessitating a chapter 11 filing.[55] The

[52] Because of consenting noteholders' unwillingness to see holdouts who do not agree to the compromise receive a more favorable deal, out-of-court exchanges are typically conditioned on near-unanimous approval despite the lack of any such legal or contractual requirement.

[53] *See* Press Release, *CEVA Group Plc Announces Final Results and Expected Successful Completion of Private Exchange Offers, Recapitalization of Its Balance Sheet and New Capital Raise* (May 2, 2013), https://www.cevalogistics.com/release/2-May-2013-1.

[54] *See* Findings of Fact, Conclusions of Law, and Order Approving the Disclosure Statement and Confirming the Second Amended and Restated Joint Prepackaged Chapter 11 Plan, *In re Cent. Eur. Dist. Corp.*, No. 13-10738 (CSS) (Bankr. D. Del. May 13, 2013), ECF No. 166.

[55] *See Colt Files for Bankruptcy, Seeks August Auction*, WALL ST. J. (June 15, 2015), http://www.wsj.com/articles/colt-files-for-bankruptcy-seeks-august-auction-1434367176.

company only emerged from bankruptcy in January 2016 after a lengthy period of negotiations with creditors.[56]

c. *Additional Considerations in Structuring Exchange Offers*

In structuring debt exchange offers, issuers can take advantage of the fact that Regulation 14D under the Exchange Act does not apply to offers to exchange non-convertible debt.[57] This means that the more restrictive rules applicable to equity tender and exchange offers, such as the "best price" and "all holders" rules, do not constrain debt exchange offers. This gives issuers the ability to consider: (a) whether to open the offer to all holders of a given security or only a subset (*e.g.*, accredited investors), (b) whether to offer added inducements to certain participants in the exchange, (c) how best to structure the mechanics of the offer, *i.e.*, withdrawal rights and time frames, (d) what disclosure documents may be necessary, and (e) whether the securities that are being issued in the exchange offer (whether debt or equity) must be registered or qualify for an exception from registration. Each of these considerations is discussed below, as are change-of-control, ratings, and tax implications of exchanges.

(i) Targeted Holders

Because an exchange offer for non-convertible securities is exempt from Regulation 14D's all holders rule, an offer for a particular class of an issuer's debt securities need not be made to every holder of such securities. To avoid the SEC registration process for the new securities, which would otherwise significantly extend the time required to complete the exchange, the offer may be conducted as a private placement open only to accredited investors. While section 3(a)(9) of the Securities Act (discussed below) provides another exemption to the registration requirements, its usefulness is limited as a practical matter when speed is a key objective because of its restrictions on the involvement of a financial advisor.

(ii) Inducements

Exchange offers for non-convertible debt are not subject to the best price rule in Rule 14d-10 under the Exchange Act. This permits an issuer to offer inducements

[56] *See* Press Release, *Colt Defense Emerges From Chapter 11 Restructuring* (Jan. 13, 2016), https://perma.cc/6FZE-DTA3.

[57] The general antifraud rules of Regulation 14E do, however, apply to debt exchange offers.

to some of the participating holders but not to others. Debt exchange offers often penalize holders that tender after a specified early tender deadline with a smaller payment for their securities than investors tendering earlier. Often, the early tender deadline is the same date as the withdrawal rights deadline, which enables an issuer to "lock in" tendering holders. This results in an issuer paying two prices in the offer—a higher price for early tenders and a lower price for those tendering after the early deadline but prior to the expiration of the offer.

(iii) Certain Mechanics

Time Periods. Regulation 14E requires that any tender or exchange offer remain open for at least 20 business days, although the SEC has generally permitted issuers to shorten the offering period to as little as five business days for a tender or exchange offer for non-convertible debt securities that meets certain criteria. If the issuer makes material changes to the amount of securities sought in the offer or to the price offered, the offer must be kept open for at least another 10 business days from the date of such change.[58]

Thresholds for Participation. Exchange offers often are coupled with consent solicitations and conditioned on high levels of participation—a minimum tender condition—often above 90%, so as to avoid significant holdouts or "free rider" problems. One consequence of this high participation level is that it may trigger change-of-control provisions in a company's debt, employment or other agreements. In those circumstances, a limit on the aggregate amount that holders can tender—a maximum tender condition—may be appropriate. In debt exchange offers undertaken to reduce debt but without a need for a specific percentage of participation, an issuer may structure the offer as an "any and all" offer without any minimum or maximum condition.

Withdrawal Rights. In tender offers for equity or convertible debt securities, Regulation 14D mandates that holders be permitted to withdraw their tenders at any time prior to an offer's expiration. Because exchange offers for non-convertible debt securities are not subject to Regulation 14D, holders of such

[58] In the case of an abbreviated offer for non-convertible debt securities, the issuer must keep the offer open for at least another five business days for a change in consideration and at least another three business days for other material changes. *See* Cahill Gordon & Reindel LLP, SEC No-Action Letter (Jan. 23, 2015), www.sec.gov/divisions/corpfin/cf-noaction/2015/abbreviated-offers-debt-securities012315-sec14.pdf; SEC Compliance and Disclosure Interpretations (Tender Offers and Schedules), Questions 162.01-162.05 (updated Nov. 18, 2016), www.sec.gov/ divisions/corpfin/ guidance/cdi-tender-offers-and-schedules.htm.

securities generally do not have withdrawal rights as a matter of law, which enables an issuer to terminate withdrawal rights in advance of the expiration of the offer. The issuer may also provide that a holder cannot revoke its consent to indenture amendments beyond a specified date, such as the early participation deadline, even if it withdraws the tendered securities.

Early Commencement. If the securities to be issued in the exchange offer will be registered, the issuer must decide whether to complete the SEC review process before launching the offering, which can take a significant amount of time, as discussed below, or to commence the offering before the SEC has completed its review. Companies may commence a registered debt tender or exchange offer before the SEC declares the registration statement effective if: (1) the company does not accept tendered securities for exchange until the registration statement is effective, (2) the company provides participants with withdrawal rights to the same extent that would be required in an offer for equity or convertible debt and (3) in the event that there is a material change in the information provided to participants, the company disseminates revised materials and holds the offer open with withdrawal rights for certain minimum time periods.[59] Although the SEC is not required to complete its review of the registration statement within a specified time period, issuers that commence an exchange offer in this manner are often able to complete the SEC review process and have the registration statement declared effective during the 20-business-day period that the exchange offer is open, particularly if the issuer thoughtfully considers and addresses potential SEC comments in the initial disclosure document. As a result, early commencement lets the issuer reduce the time from the initial filing of the registration statement to closing of the exchange offer to 20 business days if the SEC review can be completed in time. But if the SEC's review takes longer, the issuer would need to keep the offer open for more than 20 business days. In addition, early commencement of the offer requires careful coordination with the company's financial advisor and may limit the issuer's ability to "lock in" the exchange offer by terminating withdrawal rights early.

(iv) Disclosure

Registration statements filed with the SEC and offering documents distributed in exempt transactions must provide material information regarding the issuer, the exchange offer and the new securities. Such information typically includes a description of the new securities, *pro forma* financial information giving effect to

[59] 17 C.F.R. § 230.162.

the offer, and risk factors relating to the offer and the new securities. The offering documents typically will also contain or incorporate by reference information provided in an issuer's periodic reports filed with the SEC under the Exchange Act, including financial statements and management's discussion and analysis.

(v) Whether the Securities Must Be Registered

Under the Securities Act, an offering of debt or equity securities by a company in exchange for its existing obligations must be registered with the SEC and publicly disclosed unless an exemption from registration is available. The registration process, including SEC review, may take two months or even longer. The time and expense of the registration process may be more than a distressed company can bear. Also, in certain circumstances (*e.g.*, where required financial statements are unavailable, which is not uncommon for distressed companies), registration may not be possible. Consequently, if widespread solicitation and distribution are unnecessary or if an exemption from registration is otherwise available, companies frequently seek to rely on one of the Securities Act's exemptions from registration.

Section 4(2) of the Securities Act exempts from securities registration those transactions "not involving any public offering"—*i.e.*, private placements. To avoid constituting a public offering, an exchange offer generally must be privately made to a limited group of qualified investors. Private placements are most appropriately used where a small number of sophisticated holders, usually qualified institutional buyers under Rule 144A of the Securities Act, own the subject securities. The decision on whether to limit the offeree class depends primarily on the nature of the issuer's investor base and the number of participants an issuer needs to achieve its intended purpose. Securities offered under the section 4(2) exemption of the Securities Act will not be freely tradable when issued (absent the availability of another exemption), so the new securities will often carry registration rights enabling the exchanging holders, following the consummation of the offer and subsequent registration, to sell the new securities publicly.[60]

[60] On February 15, 2008, changes to the resale exemption provided by Rule 144 under the Securities Act shortened the holding period conditions pursuant to which transfers of restricted securities may take place. For reporting companies, purchasers of privately placed debt securities that are not affiliates of the issuer can freely resell these securities after six months, so long as the issuer's public filings are up to date. Nevertheless, purchasers in a private placement generally continue to request registration rights.

Section 3(a)(9) of the Securities Act exempts from registration exchanges of securities between an issuer and its existing holders if, *inter alia*, the issuer pays no commission to any person for soliciting participation in the exchange. Although an offering document with registration statement-like disclosure is used to offer the new securities, no registration is required under the Securities Act. (Issuers should note, however, that an offering document may be reviewed by the SEC in connection with a filing to qualify an indenture under the TIA.) The new securities offered will be freely tradable or restricted under the Securities Act to the same extent as the old securities for which they were exchanged. In a section 3(a)(9) offering, the solicitation activities of an issuer, as well as those of its advisors and agents, are significantly limited. For example, while an issuer's financial advisor may advise on an issuer's strategy privately and may, in some circumstances, participate in discussions with legal and financial advisors to certain institutional holders of the existing securities or a committee of such holders, it may not recommend that holders participate in the exchange.[61] Depending on the circumstances, it may not be feasible to complete an exchange if financial advisors are not permitted to actively solicit participation.

(vi) Change-of-Control Concerns

Debt-for-equity exchanges—like other transactions that alter a company's ownership—may implicate change-of-control provisions in the company's debt documents or other material contracts. In credit agreements, a change of control is often an event of default that can result in the acceleration of the debt. In bond indentures, a change of control frequently requires the company to make an offer to repurchase the bonds at a specified premium, which, for a distressed company that is short on cash, could be impossible.

Change-of-control provisions in debt documents are often drafted so they will be triggered if a person or "group" acquires a threshold percentage of the voting power of the company's voting stock. In the context of an exchange offer, the analysis often turns on the meaning of "group." Unless one entity will receive enough equity to acquire control (however "control" is defined in the debt documents), a change of control will occur only if entities receiving a sufficient

[61] *See* Exxon Mobil Corp., SEC No-Action Letter, 2002 WL 1438789 (June 28, 2002); SunTrust Banks, Inc., SEC No-Action Letter, 1999 WL 506640 (July 16, 1999); Petroleum Geo-Services ASA, SEC No-Action Letter, 1999 WL 377870 (June 8, 1999); Seaman Furniture Co., Inc., SEC No-Action Letter, 1989 WL 246436 (Oct. 10, 1989); SEC Compliance and Disclosure Interpretations (Securities Act Sections), Questions 125.06-125.07 (updated Sept. 22, 2016), https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

percentage of the company's equity are deemed a "group." The term "group" is often defined with reference to sections 13(d) and 14(d) of the Exchange Act, which ask whether individuals have agreed to act together "for the purpose of acquiring, holding, or disposing of securities."[62] While this definition is ultimately fact-specific, to be safe, institutions participating in an exchange offer should carefully consider whether to enter into any agreement or understanding to act in coordination with other holders.

(vii) Ratings Implications

Issuers considering a debt exchange offer should also consider how ratings agencies will view the exchange. An offer by a distressed issuer to exchange its debt for other securities may be viewed by the agencies as a last alternative to a true default and may therefore be treated as a default from a ratings perspective.[63] A default rating could have a material impact on an issuer's relations with trade creditors, key customers and other business partners. Even issuers acting opportunistically in proposing an exchange offer rather than as a means of dealing with financial distress must carefully evaluate whether ratings agencies will consider the exchange offer as distressed, which could lead to downgrades.

(viii) Tax Implications

The most critical tax issue for an issuer involved in an exchange offer is whether the transaction will give rise to COD income. The principle that a debtor recognizes income when its debts are forgiven or discharged at a discount is a long-standing doctrine under tax law.[64] When a borrower borrows funds, the borrower is not taxed on those funds because the borrower has an obligation to repay them. If that obligation goes away without being satisfied by full repayment, then the borrower has taxable income generally in an amount equal to the "forgiven" amount of the debt.[65] For example, if a borrower borrows $100 and then, sometime later, settles the loan for only $60, the borrower will have $40 of COD income.

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[62] 15 U.S.C. § 78m(d)(3).

[63] Standard & Poor's, *Rating Implications of Exchange Offers and Similar Restructurings* (Jan. 28, 2009); Moody's Investors Service, *Moody's Approach to Evaluating Distressed Exchanges* (Mar. 23, 2009).

[64] *United States* v. *Kirby Lumber*, 284 U.S. 1 (1931).

[65] 26 C.F.R. § 1.61-12.

COD income generally is taxable.[66] However, depending on the circumstances, issuers that incur COD income may be able to reduce, eliminate or exclude altogether such income. First, an issuer often will have substantial net operating losses ("NOLs") or current year losses. Those losses generally may be applied against the COD income.[67] If the losses are large enough, they may substantially reduce the tax that would otherwise be imposed on the COD income. Issuers relying on NOLs to reduce COD income should be aware, however, that NOLs arising in taxable years beginning after December 31, 2017 may only be used to offset up to 80% of taxable income (including COD income) for a taxable year.[68] Second, an issuer may exclude COD income if the issuer is in bankruptcy or insolvent.[69] If the issuer is insolvent, the exclusion is available only to the extent of the insolvency.[70] Any COD income excluded under the bankruptcy or insolvency exception generally must be matched by a corresponding reduction in the issuer's tax attributes, including NOLs.[71]

Exchanges. An exchange of debt for anything—new debt, stock, cash—is treated as a repayment of the original debt. As such, if the value of what is exchanged for the debt is less than the amount of the old debt, the issuer will recognize COD income. COD income generally is calculated as the excess of the "adjusted issue price" of the old debt over the price paid by the issuer to repurchase the debt.[72] In simple cases, the adjusted issue price of the old debt is its face amount. If the old debt was itself issued at a discount, then the adjusted issue price of the old debt is the issue price of the old debt, increased by any accrued original issue discount.[73]

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[66] 26 U.S.C. § 61(a)(12).

[67] 26 U.S.C. § 172(a).

[68] *Id.*

[69] 26 U.S.C. §§ 108(a)(1)(A)-(B).

[70] 26 U.S.C. § 108(a)(3).

[71] 26 U.S.C. § 108(b). Occasionally, the amount of the excluded COD income exceeds the issuer's tax attributes required to be reduced, in which case the issuer is able to exclude the excess COD income (referred to as "black hole" COD income) without any offsetting detriment.

[72] 26 C.F.R. § 1.61-12(c)(2)(ii).

[73] 26 U.S.C. § 1272(a)(4).

Debt-for-Debt Exchanges. In a debt-for-debt exchange, the issuer is treated as repaying the old debt with an amount equal to the "issue price" of the new debt.[74] The issue price of the new debt depends on whether the old debt or the new debt is "publicly traded." If the new debt is publicly traded, then the issue price is its fair market value.[75] If the new debt is not publicly traded but the old debt is publicly traded, then the issue price of the new debt is the fair market value of the old debt.[76] If neither the old debt nor the new debt is publicly traded, then, assuming that the new debt has an interest rate in excess of the "applicable federal rate" (the "AFR"), the issue price of the new debt is its face amount.[77]

To take an example, suppose that an issuer has outstanding debt of $100 that was issued some years ago for $100. Now, the issuer is in distress, the debt trades at $55, and the issuer exchanges the old debt for new debt worth $60. If the new debt is considered to be publicly traded, then the issue price of the new debt is $60 and the issuer will have $40 of COD income. If the new debt is not publicly traded but the old debt is publicly traded, then the issue price of the new debt is $55 (the fair market value of the old debt) and the issuer will have $45 of COD income. If instead neither the new debt nor the old debt is publicly traded and the new debt bears an interest rate in excess of the AFR, as normally it would, then the issue price of the new debt is $100 and the issuer will not have any COD income. Thus, a distressed issuer of publicly traded debt that is exchanged for new debt will often have COD income.

The definition of "publicly traded" changed in 2012. The prior definition was broad and anachronistic, and had been much criticized as containing numerous ambiguities, especially in light of modern trading practices.[78] In 2012, the IRS finalized new regulations intended to simplify and clarify the definition of "publicly traded."[79] Generally, under these new rules, a debt instrument is

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[74] 26 U.S.C. § 108(e)(10).

[75] 26 U.S.C. § 1273(b)(3); 26 C.F.R. § 1.1273-2(b)(1).

[76] 26 C.F.R. § 1.1273-2(c)(1).

[77] 26 U.S.C. § 1274(a)(1); 26 C.F.R. § 1.1274-2(b)(1). The applicable federal rate, or AFR, is a schedule of interest rates published by the Department of the Treasury every month.

[78] *See* NEW YORK STATE BAR ASSN. TAX SECTION, *Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273* (Aug. 12, 2004).

[79] 26 C.F.R. § 1.1273-2(f).

publicly traded if either (a) a sales price for a recently executed sale of the debt instrument is reasonably available, (b) a firm price quote to buy or sell a debt instrument is available, or (c) there is a price quote (other than a firm quote) that is provided by at least one dealer, broker or pricing service (referred to as an "indicative quote").[80] While the new definition has been praised as being clearer and simpler than under prior regulations,[81] it has generally caused more debt instruments to be treated as "publicly traded"—and thus cause more issuers to realize COD income—than under the former definition. Since price quotes or recent sale prices for debt often can be found on the internet,[82] debt that one might not expect to be publicly traded may prove to be.

As was discussed in Part I.A.2.c of this outline, because the tax law treats a "significant modification" of a debt instrument as if the old, unmodified debt were exchanged for new, modified debt, an issuer may recognize COD income as a result of a modification to a debt instrument.[83] While changing customary covenants does not give rise to a significant modification, changes in yield (taking into account any fee paid for the modification, as well as changes in the amount of principal or interest), maturity or credit support can. Thus, renegotiation of a debt instrument must be reviewed from a tax perspective to determine if it results in a significant modification. Often, in the context of a distressed company, such renegotiations will result in a significant modification for tax purposes.

OID. If a debt-for-debt exchange results in COD income, it also may generate future "original issue discount" ("OID") deductions for the issuer. To return to our example, suppose an issuer with a $100 debt outstanding exchanges the debt (or is deemed to exchange the debt) for a new debt instrument that also has a face amount of $100. Suppose that the new debt is publicly traded at a price of $60. In that event, the issue price of the new debt instrument is $60 and, as described above, the issuer will have $40 of COD income in the year of the exchange (subject to the bankruptcy or insolvency exclusions or elective deferral described

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[80] There is an exception for small debt issues. A debt instrument is not treated as publicly traded if, at the time of determination, it is part of an issue that does not exceed $100 million in principal amount. 26 C.F.R. § 1.1273-2(f)(6).

[81] *See, e.g.*, NYSBA Tax Section Report No. 1276, "Comments on Final Regulations on the Definition of Public Trading under Section 1273 and Related Issues" (Nov. 12, 2012) (also recommending that Treasury address aspects of the final regulations that "remain unclear").

[82] *See, e.g.*, FINRA TRACE System, http://www.finra.org/industry/trace.

[83] 26 C.F.R. § 1.1001-3.

below). The new debt instrument will be considered to have been issued with OID. OID is the excess of the "stated redemption price at maturity," in simple cases the face amount of the debt, over the issue price of the debt.[84] In our example, the stated redemption price at maturity generally is the face amount of $100 and the issue price is $60. Thus, the new debt has $40 of OID (not coincidentally, the same amount as the COD income on the exchange). The OID generally is deductible by the issuer over the term of the debt instrument (subject to certain limitations discussed below).[85] Thus, in a debt-for-debt exchange in which the new debt has the same principal amount as the old debt, the COD income that currently is includible in income generally is offset by the OID deductions that the issuer is entitled to over the term of the new debt. The OID deductions do not fully compensate an issuer for the tax hit resulting from the COD income because the OID deductions generally occur over the term of the new debt (and possibly over a longer period if interest deductions are subject to limitations) while the COD income generally occurs in the year of the exchange. Nonetheless, the OID deductions can ameliorate the tax cost of the COD income.[86]

New Interest Deduction Limitation. Tax reform legislation enacted in 2017 (commonly known as the "Tax Cuts and Jobs Act") introduced new rules that limit the deduction of business interest expense for taxable years beginning after December 31, 2017.[87] In general, a taxpayer's annual deduction for business interest is limited to the sum of (a) the taxpayer's business interest income for the taxable year, and (b) 30 percent of the taxpayer's "adjusted taxable income" (a measure conceptually similar to EBITDA for taxable years ending before January 2022 and EBIT for taxable years beginning after January 1, 2022).[88] Because the limitation is primarily a function of a taxpayer's taxable income,

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[84] 26 U.S.C. § 1273(a)(1).

[85] 26 U.S.C. § 163(e)(1).

[86] While a debt-for-debt exchange may result in OID for tax purposes, it may not result in OID for purposes of determining the allowable amount of a claim in bankruptcy. *See, e.g.*, *In re Chateaugay Corp*., 961 F.2d 378 (2d Cir. 1992); *Official Comm. of Unsecured Creditors* v. *UMB Bank, N.A.*, 501 B.R. 549, 586 (Bankr. S.D.N.Y. 2013); *In re Allegheny Int'l*, 100 B.R. 247 (Bankr. W.D. Penn. 1989).

[87] 26 U.S.C. § 163(j). Corporations and partnerships with gross receipts under a certain threshold (*i.e.*, average gross receipts of $25 million or less for the preceding three-year period) are not subject to the interest deduction limitation.

[88] 26 U.S.C. § 163(j)(8)(A)(v).

distressed issuers are more likely to have interest expense in excess of the limit. Disallowed interest deductions can be carried forward indefinitely, and will be treated as interest paid in subsequent taxable years.[89]

AHYDO. In the case of certain debt instruments that resemble equity (due to their high yield and lack of current cash payments), the "applicable high yield discount obligation" ("AHYDO") rules may also limit an issuer's OID deductions (in addition to the general interest deduction limitation discussed above). The AHYDO rules generally apply to a debt instrument that has a term of more than five years, a yield at least equal to the AFR plus 5%, and "significant OID," which can result when an issuer is permitted to defer paying in cash at least one year's worth of interest more than five years after issuance (for example, under "pay-in-kind" or "PIK" debt instruments).[90] If the AHYDO rules apply, interest deductions on a portion of the yield are deferred until paid in cash, and interest deductions for any excess yield are disallowed entirely.[91] To the extent that the AHYDO rules disallow a deduction for any portion of the yield, the disallowed portion instead is treated as a stock distribution for which a corporate holder may be eligible to claim a dividends-received deduction.[92]

The AHYDO rules exact a painful toll on a distressed issuer. The tax on COD income itself can be a major cost. The inability to take offsetting deductions over the term of the new debt instrument (or the deferral of those deductions until corresponding cash payments are made) as a result of the AHYDO rules exacerbates that cost.

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[89] 26 U.S.C. § 163(j)(2). However, if a taxpayer's interest expense deductions are less than the limit for any taxable year, the rules do not permit a taxpayer to carry forward the excess limitation to subsequent taxable years.

[90] "Significant OID" generally means OID accruals in excess of cash payments of interest plus one year's worth of yield, measured at any time beginning with the end of the first accrual period ending after the fifth anniversary of issuance. 26 U.S.C. § 163(e)(5).

[91] The yield that exceeds the AFR plus 6% is non-deductible, while the rest of the yield is only deductible when paid in cash. 26 U.S.C. § 163(e)(5). To avoid this problem, many loan agreements contain AHYDO "catch-up" provisions mandating that all "payable in kind" (and other) interest on a debt instrument be paid in cash by the fifth anniversary of the issue date (or the end of the first accrual period after such fifth anniversary), or the term of the debt instrument is limited to five years.

[92] 26 U.S.C. § 163(e)(5)(B).

Debt-for-Stock Exchanges. As noted above, an exchange of stock for outstanding debt also can result in COD income to the issuer because, for purposes of the COD rules, if a company issues stock in satisfaction of its indebtedness, it is treated as satisfying the debt for an amount equal to the fair market value of the stock.[93] Thus, if the face amount of the debt that is repurchased exceeds the fair market value of the stock issued in exchange, the issuer will recognize COD income in the amount of such excess. However, the tax cost of the COD income will not be ameliorated by any OID deductions that otherwise might be available in a debt-for-debt exchange because no new debt is issued.

Bankruptcy and Insolvency Exclusions for COD Income. COD income is not includible in income if the discharge of indebtedness occurs in a bankruptcy case or while the taxpayer is insolvent (but then only to the extent to which the taxpayer is insolvent).[94] However, the ability of a taxpayer to exclude COD income comes at a price. A taxpayer that excludes COD income under these rules is required to reduce its tax attributes, such as NOLs, tax credits, capital loss carryovers, and basis, by the amount of the excluded COD income.[95] If the taxpayer has no tax attributes to be reduced, the COD income may be excluded with no further consequences.[96]

NOL Limitation Under Section 382. Issuing equity, convertible securities, or warrants in exchange for debt can impair an issuer's ability to use its NOLs and other tax attributes if the exchange results in an "ownership change" (generally, a greater than 50 percentage point increase in stock ownership by one or more "5% shareholders" over a rolling three-year period or, if shorter, the period since the most recent ownership change).[97] If an exchange offer results in an "ownership

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[93] 26 U.S.C. § 108(e)(8)(A).

[94] 26 U.S.C. § 108(a)(1). If debt is owed by a wholly owned subsidiary that is a "disregarded entity" for federal tax purposes, the regarded owner is considered the "taxpayer" for purposes of applying both the insolvency and bankruptcy exceptions to COD income. 26 C.F.R. §§ 1.108-9(a)(1) & (3). Thus, COD income resulting from the discharge of indebtedness of a disregarded entity may only be excluded if the regarded owner itself is in bankruptcy or insolvent.

[95] 26 U.S.C. § 108(b).

[96] If the debtor is a member of a consolidated group, excluded COD income that is not applied to reduce the tax attributes of the debtor-member is applied to reduce the remaining consolidated tax attributes of the consolidated group. 26 C.F.R. § 1.1502-28(a)(4); *see also Marvel Entm't, LLC.* v. *Comm'r*, 842 F.3d 1291 (2d Cir. 2016), *aff'g* 145 T.C. 69 (2015).

[97] 26 U.S.C. §§ 382(a), (g).

change," the issuer's ability to use its NOLs and other tax attributes may be limited to an annual amount referred to as the "section 382 limitation."[98] As a result, an issuer that undergoes an ownership change generally will have a higher effective tax rate in subsequent years to the extent the resulting "section 382 limitation" prevents it from fully utilizing its pre-ownership-change NOLs against taxable income. Part IV.D.1.e of this outline contains a fuller discussion of the rules under section 382.

Purchases by Related Parties. If a person "related" to the issuer (as specifically defined for purposes of this rule) purchases the issuer's debt, then the debt is treated as if it had been repurchased by the issuer and subsequently reissued to the related person. Accordingly, the issuer may recognize COD income and the new debt may be deemed to be reissued with OID, making it non-fungible with other outstanding debt of the same class.

Treatment of Holders. Debt exchanges and significant modifications of debt are, in general, taxable exchanges.[99] A holder's gain or loss upon such an exchange is measured by the difference between the issue price of the new debt and the holder's tax basis in the old debt.[100] As discussed above, generally the issue price of the new debt will be its fair market value if the debt is publicly traded, and if the debt is not publicly traded (and carries an interest rate at least equal to the AFR), the issue price will be the principal amount of the new debt. A debt exchange is not taxable to a participating holder, however, if the old notes and the new notes are considered to be securities for federal income tax purposes. If that is the case, then the exchange is characterized as a "recapitalization," a type of tax-free corporate reorganization.[101] In a recapitalization, the holder does not recognize gain or loss and the holder's tax basis in the old debt generally carries over to the new debt.[102] "Securities" for this purpose are debt instruments that

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[98] Internal Revenue Code section 382 generally provides that the applicable limitation is computed by multiplying the value of the stock of the company immediately before the ownership change by the AFR. Special rules apply to ownership changes that occur in connection with bankruptcy proceedings. *See* Part IV.D.1.e.

[99] *Cottage Sav. Ass'n* v. *Comm'r*, 499 U.S. 554 (1991); 26 C.F.R. § 1.1001-3.

[100] 26 U.S.C. § 1001.

[101] 26 U.S.C. § 368(a)(1)(E).

[102] 26 U.S.C. §§ 354(a)(1) & 358.

provide an issuer with a long-term proprietary interest in the issuer.[103] Although, there is no bright line rule, debt with a term of more than 10 years (measured from the time of issuance to the time of maturity) generally is considered a security for federal income tax purposes, while debt with a term of less than five years is not.[104]

Whether or not the exchange qualifies as a recapitalization, if the new debt has OID, as described above, a holder generally will be required to include all or a portion of the OID in income over the term of the new debt.[105]

5. Foreclosure Sales and Assignments for the Benefit of Creditors

A buyer seeking to acquire assets from a distressed seller can avoid the burdens of a bankruptcy proceeding but still achieve certain of its benefits by using state law procedures for foreclosure of assets subject to security interests.

Foreclosure. In general, liens on personal property (*i.e.*, assets other than real estate) are governed by the Uniform Commercial Code, which authorizes both private and public foreclosure sales. Liens on interests in real estate, or mortgages, are governed by more complex and arcane rules of state real property law and the foreclosure procedures will vary from state to state.

An investor interested in acquiring real estate or personal property that secures debt at risk of default due to the owner's precarious financial condition can follow one of two approaches: The simpler approach is to wait for the secured party to exercise its remedies under state law and then buy the assets at the foreclosure sale. This approach has the disadvantage of not permitting the investor to control the timing of the foreclosure process or whether it occurs at all, which will instead be determined by the secured party. The alternative, more active, approach is to acquire the debt from the secured party. Acquiring the debt affords the investor

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[103] *See, e.g.*, *Le Tulle* v. *Scofield*, 308 U.S. 415, 420 (1940) ("[R]eceipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation."); *Pinellas Ice & Cold Storage Co.* v. *Comm'r*, 287 U.S. 462, 470 (1933) ("[T]o be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.").

[104] For this purpose, in measuring the term of the new debt, it may be permissible in some cases to include the period that the old debt was outstanding prior to the exchange. Rev. R. 2004-78, 2004-2 C.B. 108.

[105] 26 U.S.C. § 1272(a)(1). *See* Part I.B.4.c.viii.

greater control over the foreclosure process and allows it to credit bid, *i.e.*, use the debt as currency, for the assets at the foreclosure sale.

Compared to a private acquisition of assets outside of bankruptcy from a distressed seller, which carries fraudulent conveyance risk, as discussed in Part I.B.1.a, foreclosure has the advantage of providing a purchaser with an official imprimatur on the *bona fides* of the transaction. Accordingly, neither the price paid nor other aspects of the transaction should be subject to second-guessing if the distressed seller subsequently files bankruptcy. While this was once a matter of dispute, in *BFP* v. *Resolution Trust Corp.*, the U.S. Supreme Court rejected a fraudulent transfer challenge to a pre-bankruptcy foreclosure sale of a house, holding that any foreclosure sale in compliance with applicable state law is conclusively a sale for "reasonably equivalent value."[106]

Foreclosure on equity interests in a multi-layer ownership structure can facilitate creditors' efforts to obtain control of the bankruptcy process. For example, a number of years ago, affiliates of Carl Icahn temporarily obtained control over Marvel Entertainment Group during its bankruptcy case by acquiring structurally subordinate debt of certain holding companies and foreclosing on the equity of subsidiaries that had been pledged as collateral for the debt.[107] Similarly, in early 2011, a group led by Paulson & Co. parlayed a $200 million mezzanine loan issued by an intermediate holding company of MSR Resorts Group, which was secured by pledges of the stock of subsidiaries, into a $1.5 billion asset sale. After foreclosing on the pledged equity interests, thereby replacing Morgan Stanley Real Estate as the ultimate equity holder in control of the group's eight luxury resorts, the lenders effected an out-of-court restructuring to eliminate $800 million of debt and preferred equity. They then filed bankruptcy petitions for five of the eight resorts, and were able to confirm a plan to sell the five resorts for approximately $1.5 billion.[108]

Foreclosure need not be nonconsensual. Borrowers may consent to a foreclosure sale as an efficient means of addressing debt where bankruptcy would be costly or otherwise undesirable. Education companies Education Management and ATI

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[106] 511 U.S. 531, 545 (1994).

[107] *See In re Marvel Entm't Grp., Inc.*, 140 F.3d 463, 467 (3d Cir. 1998).

[108] *See* Findings of Fact, Conclusions of Law, and Order Confirming the Second Amended Joint Plan, *In re MSR Resort Golf Course LLC*, No. 11-10372 (SHL) (Bankr. S.D.N.Y. Feb. 22, 2013), ECF No. 2071.

Enterprises, for example, which could not file for bankruptcy without significantly harming their businesses, each cooperated with their secured lenders to effectuate foreclosure sales rather than file for bankruptcy.

Typically, credit agreements require only a simple majority of lenders to direct the agent to foreclose on collateral. Foreclosure thus may be available as a restructuring device where the majority can effectively bind dissenting holders of secured debt without the expense of a bankruptcy filing. In contrast, a supermajority—or even unanimity—may be required to approve an exchange offer or otherwise change payment terms. In 2018, API ThermaSys conducted a private, consensual strict foreclosure transaction, executed in cooperation with a majority of its senior lenders and all of its junior creditors.[109] Following the occurrence of various events of default, a group of senior lenders agreed on behalf of all senior lenders to accept a lesser amount of debt and the bulk of the company's equity in full satisfaction of the senior loan obligations.

Assignments for the Benefit of Creditors. Another state law procedure that can be useful for acquiring assets in a relatively simple transaction is known as an assignment for the benefit of creditors. This statutory procedure, which is best developed in western states such as California, allows a distressed company to assign all of its assets to a representative who then liquidates the assets and distributes the proceeds ratably among the creditors. This can be a relatively inexpensive means of acquiring the assets of a distressed company that provides some of the protections of a bankruptcy sale without the expense and delay of a bankruptcy proceeding.

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[109] *See API Heat Transfer Announces New Ownership*, BUS. WIRE, Jan. 14, 2019, https://www.businesswire.com/news/home/20190114005269/en/API-Heat-Transfer-Announces-New-Ownership.

II.

Prepackaged and Pre-Negotiated Bankruptcy Plans

When the methods to restructure a company's balance sheet or debt maturities out of court (discussed in Part I) are unsuccessful, a distressed company may decide to use the bankruptcy process. In a conventional chapter 11 bankruptcy, after filing its bankruptcy petition, the debtor negotiates the terms of its reorganization plan, obtains approval of a disclosure statement, solicits votes, and then requests plan confirmation, all under the supervision of the bankruptcy court. "Prepackaged" and "pre-negotiated" chapter 11 plans are intended to minimize the disadvantages of the bankruptcy process—which include delay and expense—while still taking advantage of its many benefits. In a *pre-negotiated* plan, the plan distribution and other terms are negotiated prior to filing the petition, and are often memorialized in a "lock-up" or "restructuring support" agreement between a company and its principal creditors; vote solicitation in this context principally occurs after the bankruptcy filing. In a *prepackaged* plan, both the negotiation of the plan and the solicitation of votes take place before the filing. In recent years, a majority of large company bankruptcy filings have been prepackaged and pre-negotiated plans, as opposed to "free fall" bankruptcy filings.[110]

Part II of this outline details the steps necessary for the implementation of a prepackaged or pre-negotiated bankruptcy plan, and discusses the costs and benefits of each for potential investors.

A. Prepackaged Plans

1. Generally

The Bankruptcy Code provides mechanisms for the conduct of a shortened chapter 11 case to secure confirmation, or bankruptcy court approval, of prepackaged plans. A debtor may file a plan simultaneously with its bankruptcy petition[111] and seek confirmation of that plan on the basis of votes solicited before

[110] In an analysis of large chapter 11 cases from January 2010 to June 2018, researchers found that an average of 65% of the cases filed between 2016 and 2018 were prepackaged or pre-negotiated filings, as compared to an average of 44% between 2010 and 2015. John Yozzo & Samuel Star, *For Better or Worse, Prepackaged and Pre-Negotiated Filings Now Account for Most Reorganizations*, 37 AM. BANKR. INST. J., No. 11 (Nov. 1, 2018), https://www.abi.org/node/269843.

[111] 11 U.S.C. § 1121(a).

the bankruptcy filing.[112] A committee of creditors established prior to a bankruptcy filing may continue to serve as the official creditors' committee in bankruptcy.[113]

In appropriate situations, prepackaged plans (or "prepacks") have many advantages. They reduce litigation costs by committing major constituencies to a negotiated course of action and generally are less disruptive to a company's operations and prospects. Prepacks also minimize the time that a company needs to be in bankruptcy by enabling the case to proceed directly to confirmation of a reorganization plan and reducing the scope and extent of judicial involvement in the life of the company. The process of building a consensus on the terms of a transaction can proceed without the publicity that an immediate bankruptcy court filing would yield. To the extent stakeholders are informed, the promise of a short proceeding and the existence of a prepackaged plan may induce constituencies such as trade creditors—that would otherwise shun (or demand onerous terms from) a distressed company—to continue to do business with the company more or less as usual. Prepackaged plans also are often "stapled" to exchange offers as an inducement for hold-out lenders to consent, as acceptance of a plan of reorganization by an impaired class of claims requires only two-thirds by dollar amount, and a majority in number, of the claims that vote in that class. *See* Part I.B.4.b.

As with out-of-court workouts, prepackaged plans are best suited for companies that are over-levered, rather than operationally flawed. Indeed, the paradigmatic use of a prepackaged bankruptcy is when an out-of-court restructuring would be optimal, but bankruptcy law is needed to bind a minority of non-consenting creditors whose participation is necessary to complete a deal. For instance, in August 2013, Anchor BanCorp Wisconsin, a bank holding company, filed for bankruptcy with a prepackaged plan after one creditor rejected a negotiated deal that would have restructured its outstanding debt.[114] In recent years, several

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[112] 11 U.S.C. § 1126(b).

[113] 11 U.S.C. § 1102(b)(1). The pre-established committee must be "fairly chosen" and "representative of the different kinds of claims to be represented." *Id.*

[114] *See Anchor BanCorp: Associated Bank Declined a Deal, Forced Bankruptcy*, BELOIT DAILY NEWS, Aug. 15, 2013, www.beloitdailynews.com/news/anchor-bancorp-associated-bank-declined-a-deal-forced-bankruptcy/article_b1b47850-05c3-11e3-b054-001a4bcf887a.html; *see also* Order Approving Prepetition Solicitation Procedures and Confirming Plan of Reorganization, *In re Anchor Bancorp Wis. Inc.*, No. 13-14003 (Bankr. W.D. Wis. Aug. 30, 2013), ECF No. 71.

energy companies, including Key Energy,[115] Halcón Resources,[116] and Atlas Resource Partners (now Titan Energy),[117] have completed quick prepackaged bankruptcies, confirming plans within as little as two months. A similar trend has emerged in the oil & gas industry,[118] with confirmation of one company's prepackaged bankruptcy occurring in just 17 days.[119] In early 2019, retailer FullBeauty Brands Inc. completed its prepackaged bankruptcy in under 24 hours, the fastest chapter 11 case in history.[120]

Prepackaged plans have even been used to effect mergers. In March 2013, for example, two yellow pages publishers, Dex One Corporation (formerly known as R.H. Donnelley) and SuperMedia Inc., which had previously agreed to merge, separately filed for bankruptcy in the District of Delaware with prepackaged plans that would bind a small minority of each company's senior secured lenders who

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[115] Press Release, Key Energy Services Emerges from Bankruptcy, to Relist on the New York Stock Exchange and Resume Trading Under Ticker "KEG" (Dec. 15, 2016), https://www.prnewswire.com/news-releases/key-energy-services-emerges-from-bankruptcy-to-relist-on-the-new-york-stock-exchange-and-resume-trading-under-ticker-keg-300379411.html.

[116] Press Release, Halcón Resources Completes Restructuring and Exits Prepackaged Bankruptcy (Sept. 9, 2016), http://globenewswire.com/news-release/2016/09/09/870911/0/en/Halc%C3%B3n-Resources-Completes-Restructuring-and-Exits-Prepackaged-Bankruptcy.html.

[117] Press Release, Atlas Resource Partners Receives Approval of its Prepackaged Restructuring (Aug. 26, 2016), http://phx.corporate-ir.net/phoenix.zhtml?c=251151&p=irol-newsArticle&ID=2197752.

[118] Oil and gas companies have utilized prepackaged bankruptcies at a higher rate than other industries. *See* Joshua Friedman & Jack M. Tracy II, *Data-Driven Insights: Restructuring Entrance & Exit Trends*, ABL ADVISOR, May 23, 2018, http://www.abladvisor.com/articles/14074/data-driven-insights-restructuring-entrance-exit-trends (noting that from 2016 to 2018, oil and gas bankruptcies used "pre-arranged and pre-packed bankruptcy filings at a significantly higher clip than any other sector"). In 2017, the oil and gas, energy, and mining industries accounted for 30% of public company filings. *2017 Corporate Bankruptcy Review: Energy & Retail Sectors Dominate; Prepackaged Chapter 11 Bankruptcies Up 75% and Looming Debt Maturities Point to Increased Chapter 11 Activity*, BANKRUPTCY DATA, Jan. 10, 2018, www.bankruptcydata.com/public/assets/filemanager/userfiles/BankruptcyData_2017_Corporate_Bankruptcy_Review.pdf.

[119] Elliot Smith, *A Trip Through an Oil and Gas Bankruptcy – In Only Seventeen Days*, ESQUIRE GLOB. CROSSINGS, May 02, 2016, www.esquireglobalcrossings.com/2016/05/a-trip-through-an-oil-and-gas-bankruptcy-in-only-seventeen-days/.

[120] Soma Biswas, *Judge Approves FullBeauty's Record 24-Hour Bankruptcy Case*, WALL ST. J., Feb. 4, 2019, https://www.wsj.com/articles/fullbeauty-attempts-record-24-hour-bankruptcy-case-11549310368.

had refused to agree to amendments necessary to enable the merger outside of bankruptcy.[121]

Though prepackaged bankruptcies can achieve efficient debt restructuring, as discussed in Part III of this outline, "traditional" bankruptcy affords significant opportunities to improve aspects of a company's operating environment, such as rejecting onerous and burdensome executory contracts and leases. While it is possible to undertake such bankruptcy "fixes" in a prepackaged bankruptcy, doing so may lead to litigation and delays, thus undermining the advantages of proceeding with a prepack, as well as potentially complicating voting procedures by creating new classes of claims whose consent to the plan must be solicited. Further, in arranging a prepackaged bankruptcy, it is desirable to have as many "unimpaired" classes of claims as possible since classes that are "unimpaired" under a prepackaged plan will be deemed to have accepted the plan under section 1126 of the Bankruptcy Code without the requirement of a vote.

It is particularly difficult to implement a prepackaged plan in which general trade creditors will receive less than 100% on their claims. First, trade creditors, unlike bondholders and lending groups, generally are not represented by a single agent or trustee, making solicitation difficult absent the procedures available under the Bankruptcy Code. Second, trade claims fluctuate constantly as a company operates day to day, making it difficult, absent a set bankruptcy filing date, to accurately estimate the amount of claims and the number and identities of trade claimants. Finally, negotiations for a prepackaged plan alert creditors that a bankruptcy filing is imminent; if trade creditors do not receive satisfactory assurance that they will be paid in full in bankruptcy, then trade credit is likely to dry up during the pre-bankruptcy negotiation and solicitation period, thereby exacerbating a company's financial difficulties.

2. Requirements

At least some of the financial benefits of prepackaged bankruptcies are offset by the costs associated with prepetition bargaining and solicitation (including, as described below, the time and expense required to comply with the federal securities laws, if applicable). Achieving the other benefits of a prepackaged plan requires close attention to the procedural requirements surrounding pre-

[121] Motion of Dex One Corporation, *et al.* for Entry of an Order Directing Joint Administration of Their Chapter 11 Cases at 6-8, *In re Dex One Corp.*, No. 13-10533 (Bankr. D. Del. Mar. 18, 2013), ECF No. 2; Motion for Joint Administration of Debtors' Chapter 11 Cases, *In re SuperMedia Inc.*, No. 13-10545 (Bankr. D. Del. Mar. 18, 2013), ECF No. 2.

bankruptcy vote solicitation. A proponent of a prepackaged plan takes a calculated risk that at the confirmation stage of the chapter 11 case, the bankruptcy court may determine that the pre-bankruptcy disclosure and solicitation process was inadequate. In such a case, a second solicitation in bankruptcy—with attendant delay and cost—will be required.[122]

Under section 1126(b) of the Bankruptcy Code, pre-bankruptcy solicitations of chapter 11 plan votes must either have complied with applicable non-bankruptcy law or meet the requirements for disclosure statements that accompany a plan of reorganization in a conventional bankruptcy case. Rule 3018(b) of the Federal Rules of Bankruptcy Procedure additionally requires that the materials used to solicit votes be submitted to substantially all members of a class of claims or interests and that a reasonable time be provided for such class members to vote. Although there is no firm rule as to what constitutes a reasonable time period, 28 days—the minimum time specified for considering a disclosure statement in bankruptcy[123]—is often considered to be a safe minimum time period for voting as well.

Importantly, any contemplated solicitation of votes on a prepack under which new securities are being offered must confront the unsettled question of whether such new securities would be exempt from the registration requirements of the Securities Act. Section 1145(a) of the Bankruptcy Code exempts from registration new securities of a reorganized debtor that are exchanged for pre-bankruptcy securities under a confirmed chapter 11 plan. This provision would seem to provide a safe harbor for the issuance of new securities under a confirmed prepack. However, it is uncertain whether section 1145's exemption applies to a prepetition solicitation of votes for a prepack, since the text of section 1145 exempts only "a security of the debtor" from registration, whereas the issuer technically is not a "debtor" until a chapter 11 proceeding is commenced.

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[122] *See, e.g.*, *In re Colo. Springs Spring Creek Gen. Imp. Dist.*, 177 B.R. 684, 691 (Bankr. D. Colo. 1995) (noting that "[a] proponent of a prepackaged plan takes a substantial risk that . . . the Court may determine that the proposed disclosure statement or process of solicitation are inadequate" and observing that "'any shortcoming . . . would require going back to the drawing board for a bankruptcy regulated disclosure statement hearing with notice, and the usual bankruptcy process toward a hearing on confirmation'" (quoting *In re Southland Corp.*, 124 B.R. 211, 225 (Bankr. N.D. Tex. 1991)).

[123] Fed. R. Bankr. P. 2002(b).

Although not definitive, the SEC staff has indicated in the past that the section 1145 exemption is not available for prepacks.[124]

The Bankruptcy Code also requires compliance with certain formalities to qualify for treatment as a prepackaged plan, including the need to solicit *beneficial* holders of securities (*i.e.*, the accountholders with the ultimate right to payment on the bonds), and to demonstrate that record holders (*i.e.*, the brokers, dealers, and other entities listed as owners with the indenture trustee) have authority to vote securities held in their name in connection with a bankruptcy plan. In *In re Pioneer Finance Corp.*, for example, a prepackaged plan solicitation was held not to qualify under section 1126(b) of the Bankruptcy Code because, although the solicitation package was sent to record holders, there was no evidence that the information package was forwarded to the beneficial holders of the bonds or that the record holders were authorized to vote on the beneficial holders' behalf.[125] It is now typical for plan proponents to request that brokers forward the plan solicitation materials to their customers who hold the bonds in their accounts and aggregate the customers' votes in master ballots.

B. Pre-Negotiated Plans

1. Generally

In recent years, distressed practice has moved toward pre-negotiated, rather than prepackaged, plans. According to one database, 18% of chapter 11 bankruptcies filed in 2016 were pre-negotiated, while 8% were prepackaged. The trend continued in 2017, in which 24% of chapter 11 filings were pre-negotiated bankruptcies and 12% were prepackaged.[126] This shift is due in large part to the potential for judicial second-guessing of the disclosure and solicitation process employed pre-bankruptcy in the prepack context, and to the increasing tolerance

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[124] SEC Division of Corporation Finance, Compliance and Disclosure Interpretations: Securities Act Sections, Question 125.11 (June 4, 2010), https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm.

[125] 246 B.R. 626, 634 (Bankr. D. Nev. 2000) ("While record holders may vote on behalf of beneficial holders outside of bankruptcy under the federal securities laws, under § 1126 of the Bankruptcy Code it is the 'holder of a claim or interest' who is entitled to receive a plan solicitation package and to vote.").

[126] Data collected from Debtwire's compilation of Restructuring Data and analyzed by Wachtell, Lipton, Rosen & Katz. *See* DEBTWIRE RESTRUCTURING DATA, https://www.debtwire.com/restructuringdb/cases/ (last visited Feb. 8, 2019).

of many financial market players to companies operating in bankruptcy. Pre-negotiated transactions necessitate a longer stay in bankruptcy for a distressed company than prepacks because the solicitation and voting process occurs postpetition. However, given the minimum offer periods applicable to prepacks in the tender and bankruptcy rules, pre-negotiated plans need not take much longer to consummate in the aggregate than prepackaged plans.

Because the disclosure statement and other solicitation procedures and materials are approved by the bankruptcy court in advance, pre-negotiated plans eliminate the risk presented by a prepack of a later finding of a flawed solicitation. As discussed at greater length in Part III.B.2.i of this outline, the disclosure statement sets forth the terms of a proposed plan of reorganization and provides adequate information required by creditors and interest holders to vote on the plan, including information on a debtor's prepetition capital structure and the circumstances that resulted in its chapter 11 filing. While disclosure statements can be lengthy documents, their basic form and content are well established, and pre-negotiated cases may move quickly to the required hearing to consider the adequacy of a disclosure statement, especially if it is drafted prior to the filing. Although any interested party may object to a proposed disclosure statement and related procedures, even successful objections tend not to delay the plan process significantly, since the typical remedy is simply to expand disclosure.

Like prepacks, pre-negotiated plans can have significant advantages relative to both out-of-court restructurings and conventional chapter 11 filings. Those advantages may include:

- minimizing negative publicity or reputational harm;
- minimizing judicial scrutiny and inquiry;
- lowering administrative expenses;
- avoiding a formal auction (at least where the plan is not premised on the new value exception, which is discussed in Part III.B.2.h of this outline); and
- availability of clean title, fraudulent transfer protection and other protections of a bankruptcy court order.

Realizing these advantages often requires significant planning and, in particular, agreements that secure the support of key constituencies, as described below.

2. Restructuring Support Agreements

Restructuring support agreements are agreements to propose, vote in favor of, or otherwise support a particular chapter 11 plan or a sale of assets under section 363 of the Bankruptcy Code. Such agreements are an essential component of pre-negotiated chapter 11 plans. With the benefit of a restructuring support agreement among key constituents, an acquiror of a company may enter the chapter 11 process knowing that its transaction has the requisite support and at least some protection against a retrade of the transaction.

However, a restructuring support agreement cannot provide a bidder with ironclad protection against its proposed transaction being renegotiated or abandoned because a chapter 11 debtor has a fiduciary obligation to creditors to seek higher and better bids. Still, a bidder that has locked up the key players does not enter the chapter 11 process entirely exposed. At a minimum, a prepetition restructuring support agreement should provide some certainty for a bidder that is required to lock in financing and pay commitment fees or other third-party costs for which it will receive expense reimbursement if its bid is ultimately topped.

Prepetition restructuring support agreements also can be useful in gaining control over the many different constituencies that a complex capital structure may entail. For example, the 2008 merger of American Color Graphics and Vertis Holdings, Inc. was accomplished through dual prepackaged chapter 11 cases that were preceded by restructuring support agreements.[127] The restructuring support agreements were essential to the completion of negotiations among the many competing constituencies of the two companies.[128] In addition, restructuring support agreements can be useful in curtailing the costs of bankruptcy. For example, such agreements were instrumental in the rapid exits from bankruptcy of Eagle Bulk Shipping and Genco Shipping & Trading Limited in 2014. Several of the largest bankruptcy filings of 2018, including those of retailers Claire's,[129]

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[127] *See* Motion of the Debtors for an Order Directing Joint Administration of Their Related Chapter 11 Cases at 4-6, *In re ACG Holdings, Inc.*, Case No. 08-11467 (CSS) (Bankr. D. Del. July 15, 2008), ECF No. 4 (describing prepackaged chapter 11 plans and merger).

[128] In some circumstances, lock-up agreements also can be used postpetition to "lock in" a deal before a chapter 11 plan is proposed. As discussed in Part III.B.10.a of this outline, however, postpetition lock-up agreements face greater obstacles than their prepetition counterparts because of the restrictions imposed by the Bankruptcy Code on the plan solicitation process.

[129] Claire's Stores Inc., Current Report, items 1.01, 1.03, 2.02, 2.04, 7.01, and 9.01, at Ex. 10.1 (Form 8-K) (Mar. 19, 2018) (Restructuring Support Agreement, dated Mar. 19, 2018).

Nine West,[130] and David's Bridal,[131] also involved prepetition restructuring support agreements.

Potential buyers should be aware that inclusion of significant backstop fees payable to only a subset of their creditors in prepetition restructuring support agreements can prove problematic. Excluded creditors in the cases of Bonanza Creek Energy,[132] Peabody Energy,[133] and CHC Group[134] all challenged large "backstop fees" embedded in prepetition restructuring support agreements for treating similarly situated creditors inequitably and as unjustified uses of estate funds. Excluded creditors often also argue that prepetition restructuring support agreements are improper *sub rosa* plans[135] that impermissibly lock in payment terms prior to plan confirmation without any of the procedural protections afforded to creditors in the typical chapter 11 plan confirmation process.

Even where an RSA is not ultimately approved, though, it may set the baseline for structural and other issues in the reorganization. In the 2014 bankruptcy of Energy Future Holdings, the debtors filed the case with a restructuring support agreement in place.[136] Although the agreement was ultimately not approved and

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[130] *Nine West Reaches Restructuring Support Agreement with Lenders, Commences Chapter 11 Cases and Secures Interim Approval of DIP Financing* (Apr. 12, 2018), https://www.davispolk.com/news/nine-west-reaches-restructuring-support-agreement-lenders-commences-chapter-11-cases-and.

[131] Katherine Doherty, *David's Bridal Files for Bankruptcy with Plan to Stay Open*, BLOOMBERG (Nov. 19, 2018), https://www.bloomberg.com/news/articles/2018-11-19/david-s-bridal-files-for-chapter-11-bankruptcy-in-delaware-jooc4qaf.

[132] Objection of GMO Credit Opportunities Fund, L.P. and Glob. Credit Advisers, LLC to Debtors' Motion to Approve Backstop Commitment Agreement, *In re Bonanza Creek Energy, Inc.*, No. 17-10015-KJC (Bankr. D. Del. Feb. 3, 2017), ECF No. 224.

[133] Objection of the Mangrove Partners Master Fund, Ltd. to Debtors Motion for an Order Approving Backstop Commitment Agreement, *In re Peabody Energy Corp.*, No. 16-42529 (Bankr. E.D. Miss. Jan. 12, 2017), ECF No. 1961.

[134] Objection to Motion for an Order Authorizing the Debtors to Enter into Backstop Agreement, *In re CHC Grp., Ltd.*, No. 16-31854 (Bankr. N.D. Tex. Nov. 10, 2016), ECF No. 1164.

[135] We discuss the *sub rosa* doctrine in Part III.A.1.b.

[136] *See* Motion of Energy Future Holdings Corp., *et al.*, for Entry of an Order Authorizing the RSA Debtors to Assume the Restructuring Support Agreement and Modifying the Automatic Stay, *In re Energy Future Holdings Corp.*, No. 14-10979 (Bankr. D. Del. May 16, 2014), ECF No. 505.

was terminated three months into the case,[137] it set a basic framework for a tax-free restructuring that remained a consistent paradigm for plan negotiations throughout the four-year case.[138]

C. Pre-Negotiated Section 363 Sales

A "section 363" sale of all or a portion of a distressed company's assets must, by definition, occur in bankruptcy (pursuant to section 363 of the Bankruptcy Code). However, stalking-horse bidders may be, and often are, lined up prior to the bankruptcy filing. Although a negotiated acquisition agreement ultimately will be subject to higher and better bids and require court approval, prepetition stalking-horse bids may be advantageous to both would-be buyers and distressed sellers. Buyers get lead time to conduct diligence and negotiate a sensible and favorable agreement at a time when target management is not diverted by the bankruptcy process itself. Sellers get the comfort of avoiding a "free-fall" bankruptcy and are better able to preserve going-concern value by providing some assurance of business continuity to suppliers, employees and other stakeholders.

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[137] *See* Debtors' Notice of Termination of Restructuring Support Agreement, *In re Energy Future Holdings Corp.*, No. 14-10979 (Bankr. D. Del. July 25, 2014), ECF No. 1697.

[138] *See* Maria Chutchian, *Texas Utility Giant EFH Poised to Exit Bankruptcy after Three Years*, FORBES, Feb. 16, 2017, https://www.forbes.com/sites/debtwire/2017/02/16/texas-utility-giant-efh-poised-to-exit-bankruptcy-after-three-years/#491852b23a6b.

III.

Acquisitions Through Bankruptcy

There is a limited period of time to orchestrate a pre-negotiated or prepackaged bankruptcy. While a financially distressed target is negotiating transaction details, its debt may mature and its cash may run out. Thus, a company may be forced to enter into bankruptcy without having a pre-arranged exit strategy. One potential strategy for a distressed company is to sell itself, or all or substantially all of its assets, or to shed certain businesses or assets, under the protection of the bankruptcy process. Such sales can occur either through a sale conducted under section 363 or through a plan of reorganization confirmed under section 1129 of the Bankruptcy Code. Generally, sales are a relatively expeditious process to sell assets that are rapidly losing value. In contrast, the full bankruptcy process is more deliberate and time-consuming and involves developing a plan of reorganization, drafting and obtaining approval of a disclosure statement, soliciting votes on the plan, and confirming the plan with a court order. Part III of this outline details how to participate as a potential acquiror in section 363 sales and plans of reorganization and highlights the benefits and costs of each, as well as the roles that a potential purchaser may choose to play.

A. Acquisitions Through a Section 363 Sale

While in the early years after enactment of the Bankruptcy Code in 1979 the expectation was that any significant transactions would occur pursuant to a confirmed chapter 11 plan, significant asset sales occurring during large business bankruptcies have become routine. The prevalence of section 363 sales has markedly increased over the years,[139] with 45% of chapter 11 cases filed in both 2017 and 2018 resulting in section 363 sales.[140]

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[139] By comparison, according to one researcher, only 15% of all large public-company bankruptcies in 2000 resulted in section 363 sales of all or substantially all assets. *363 Sales of All or Substantially All Assets in Large, Public Company Bankruptcies, as a Percentage of All Cases Disposed, by Year of Case Disposition*, UCLA-LOPUCKI BANK. RES. DATABASE, http://lopucki.law.ucla.edu/tables_and_graphs/363_sale_percentage.pdf (last visited Mar. 2, 2019).

[140] Data collected from Debtwire's compilation of Restructuring Data and analyzed by Wachtell, Lipton, Rosen & Katz. *See* DEBTWIRE RESTRUCTURING DATA, www.debtwire.com/restructuringdb/cases/ (last visited Feb. 2, 2019).

There are several reasons for this shift. Hedge funds, which hold a dominant place among debtholders, are typically more interested in, and structurally suited for, quick sales of the debtor (rather than long-term restructurings). Strategic and financial purchasers have also become increasingly sophisticated and less concerned about the "taint" of bankruptcy on the debtor's assets than in the past. And, as a general matter, parties are mindful of the high cost of protracted bankruptcy proceedings and their potential to destroy value.

Section 363 sales are attractive to buyers because they allow them to obtain ownership of and control over a distressed asset or business quickly. Section 363 sales are attractive to debtors because the advantages of the process can increase the price a buyer is willing to pay.

1. Overview of Section 363 of the Bankruptcy Code

Section 363 of the Bankruptcy Code authorizes a trustee or a debtor to sell all or part of a debtor's assets. Transactions that occur on a day-to-day or other routine basis, such as a retailer's sale of inventory to customers, are considered to be in the ordinary course of business and do not require approval of the bankruptcy court. On the other hand, the sale of all or a significant portion of a debtor's assets, or an otherwise large or unusual transaction, will be a sale outside the ordinary course of business, requiring notice to interested parties and bankruptcy court approval under section 363(b)(1).

When a debtor's assets are to be sold outside the ordinary course of business pursuant to section 363, courts typically require an auction to be conducted in order to ensure that the sale price reflects the "highest and best offer."[141] A competitive auction allows the debtor and its creditors to test the market and potentially obtain a higher sale price than could be obtained by other means.

[141] *In re Moore*, 608 F.3d 253, 263 (5th Cir. 2010). *See, e.g.*, *In re GSC, Inc.*, 453 B.R. 132, 169 (Bankr. S.D.N.Y. 2011); *In re Atlanta Packaging Prods., Inc.*, 99 B.R. 124, 130 (Bankr. N.D. Ga. 1988) ("It is a well-established principle of bankruptcy law that the objective of bankruptcy sales and the trustee's duty with respect to such sales is to obtain the highest price or greatest overall benefit possible for the estate.").

a. *Standard for Approval of Sales Outside the Ordinary Course*

(i) Justification for the Sale

In the past, significant asset sales outside of a plan of reorganization had to be justified by special circumstances,[142] and were most readily permitted in cases of emergency, or where the relevant assets were deteriorating in value or perishable, *i.e.*, the proverbial "melting ice cube," such that, absent a prompt sale, the value available to creditors would be irretrievably lost.[143]

Bankruptcy courts now routinely approve sales of significant assets under section 363 based on a showing that the sale is justified by a "good business reason."[144]

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[142] *See, e.g.*, *In re Summit Glob. Logistics, Inc.*, 2008 WL 819934, at *9 (Bankr. D.N.J. Mar. 26, 2008) ("[W]hen a pre-confirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization.'" (quoting *In re Med. Software Sols.*, 286 B.R. 431, 455 (Bankr. D. Utah 2002)); *In re Channel One Commc'ns, Inc.*, 117 B.R. 493, 496 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re Indus. Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a pre-confirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business—including provision of proper notice, adequacy of price, and 'good faith'—is heightened").

[143] Prior to enactment of the Bankruptcy Code in 1978, many courts regarded the existence of an "emergency" or "perishability" as a threshold requirement for a sale of substantial assets out of the ordinary course of business. *See, e.g.*, *In re Pure Penn Petroleum Co.*, 188 F.2d 851, 854 (2d Cir. 1951) (debtor must prove "existence of an emergency involving imminent danger of loss of the assets if they were not promptly sold"); *In re Solar Mfg. Corp.*, 176 F.2d 493, 494 (3d Cir. 1949) (preconfirmation sales should be "confined to emergencies where there is imminent danger that the assets of the ailing business will be lost if prompt action is not taken"). The Bankruptcy Code, by contrast, does not contain such a requirement. *See In re Lionel Corp.*, 722 F.2d 1063, 1069 (2d Cir. 1983) ("[T]he new Bankruptcy Code no longer requires such strict limitations on a bankruptcy judge's authority to order disposition of the estate's property; nevertheless, it does not go so far as to eliminate all constraints on that judge's discretion.").

[144] The standard for approval was set forth by the U.S. Court of Appeals for the Second Circuit in *In re Lionel Corp.*, 722 F.2d at 1071, which held that in order to approve sales of major assets outside a plan of reorganization, the bankruptcy court must be presented with evidence that there is a "good business reason" for the proposed sale. *See also In re Bos. Generating, LLC*, 440 B.R.

For example, in the auto company bankruptcies during the financial crisis, Chrysler and GM were both permitted to sell substantially all of their assets within weeks of their bankruptcy filings.[145] In retail cases, where the debtors are particularly vulnerable to a rapid erosion of value, it is not uncommon for DIP lenders to condition financing on a speedy sale process.[146] For a retail debtor, any significant delay can result in a decline in operating revenues, customer confidence and market share, as well as employee attrition and erosion of the inventory base, while operating costs continue to run, thus potentially destroying the company's ability to continue as a going-concern or severely eroding the liquidation value of its assets.[147] Financial firms are another example in which rapidly deteriorating enterprise value has justified a sale: Lehman Brothers was permitted to sell its multi-billion dollar broker-dealer business within days of its

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302, 329 (Bankr. S.D.N.Y. 2010) (although the debtors might not "die on the operating table" if the sale were deferred, it approved an immediate sale over the junior lenders' objection that the company would fetch a higher price in the future, finding that the company would soon be severely cash-constrained and that "there well could be degradation in the value of their assets simply because buyers may perceive that the Debtors needed to sell the assets immediately").

[145] *In re Gen. Motors Corp.*, 407 B.R. 463, 491-92 (Bankr. S.D.N.Y. 2009); *see In re Chrysler LLC*, 576 F.3d 108 (2d Cir. 2009), *aff'g In re Chrysler LLC*, 405 B.R. 84, 96-97 (Bankr. S.D.N.Y. 2009). The Second Circuit's decision was vacated on the technical ground that the case became moot before the Supreme Court could hear an appeal. *Ind. State Police Pension Tr.* v. *Chrysler LLC*, 558 U.S. 1087 (2009).

[146] *See, e.g.*, Vicki M. Young, *Nine West, Bandolino Brands Sold to ABG for $340 Million*, WWD, June 11, 2018, https://wwd.com/fashion-news/fashion-scoops/nine-west-bandolino-brands-sold-to-abg-authentic-brands-group-bankruptcy-340m-1202702786/ (approximately two months between petition date and sale); Press Release, The Bon-Ton Stores, Inc., *The Bon-Ton Stores, Inc. Announces Winning Bid in Bankruptcy Court-Supervised Auction* (Apr. 17, 2018), https://www.prnewswire.com/news-releases/the-bon-ton-stores-inc-announces-winning-bid-in-bankruptcy-court-supervised-auction-300631884.html (approximately two months between petition date and sale).

[147] *See, e.g.*, Order Authorizing the Sale of Substantially All of the Debtors' Assets, *In re Orchard Supply Hardware Stores Corp.*, No. 13-11565 (Bankr. D. Del. Aug. 20, 2013), ECF No. 489. Orchard Supply filed for bankruptcy with a stalking-horse bid from Lowe's to purchase a majority of the company's 91 stores pursuant to a section 363 sale. *Lowe's Enters into Purchase Agreement with Orchard Supply Hardware*, BUS. WIRE, June 17, 2013, www.businesswire.com/news/home/20130616005087/en/Lowe%E2%80%99s-Enters-Purchase-Agreement-Orchard-Supply-Hardware.

chapter 11 filing because the value of the business was rapidly eroding due to customer and counterparty defections.[148]

Notwithstanding these developments, some judicial reluctance to allow significant asset sales in chapter 11 cases prior to confirmation of a plan of reorganization remains, particularly where the benefit of the sale is limited to secured creditors whose collateral is being disposed of.[149]

(ii) Robust Auction

While section 363(b) does not explicitly require an auction, a public auction process "has developed over the years as an effective means for producing an arm's-length fair value transaction."[150] A proposed sale may be disapproved if the court finds that the debtor did not conduct a robust sale process.[151] Conversely, a court will be more likely to be persuaded that a sale price is fair if there is evidence of substantial prior marketing of the assets sold. In the Boston Generating bankruptcy, for example, the debtors held a competitive prepetition auction to obtain a stalking-horse bid, and then continued to solicit higher offers (which ultimately did not emerge) while in bankruptcy. Junior creditors, relying

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[148] Order Authorizing and Approving the Sale of Purchased Assets, *In re Lehman Bros. Holdings, Inc.*, No. 08-13555 (Bankr. S.D.N.Y. 2008), *aff'd*, 415 B.R. 77, 79 (S.D.N.Y. 2009).

[149] See *In re Gulf Coast Oil Corp.*, 404 B.R. 407, 428 (Bankr. S.D. Tex. 2009) (denying approval of section 363 sale of the entire company to its sole secured lender, reasoning that the proposed transaction was essentially a "foreclosure supplemented materially by a release, by assignment of executory contracts (but only the contracts chosen by the secured lender), by a federal court order eliminating any successor liability, and by preservation of the going concern"; obtaining these additional benefits, the court held, requires confirmation of a plan of reorganization).

[150] *In re Trans World Airlines, Inc.*, 2001 WL 1820326, at *4 (Bankr. D. Del. Apr. 2, 2001). Several courts have held that four elements are necessary to gain approval of a sale of all or substantially all of a debtor's assets under section 363: (1) accurate and reasonable notice to all creditors and interested parties, (2) a sound business purpose, (3) a "fair and reasonable" price and (4) good faith, *i.e.*, that the sale does not unfairly benefit insiders or the purchaser. *See, e.g.*, *In re Gen. Motors Corp.*, 407 B.R. at 493-94; *In re Exaeris, Inc.*, 380 B.R. 741, 744 (Bankr. D. Del. 2008) (citing *In re Del. & Hudson Ry. Co.*, 124 B.R. 169, 176 (D. Del. 1991)); *Polvay* v. *B.O. Acquisitions, Inc. (In re Betty Owens Schs., Inc.)*, 1997 WL 188127, at *4 (S.D.N.Y. Apr. 17, 1997); *In re WBQ P'ship*, 189 B.R. 97, 102 (Bankr. E.D. Va. 1995); *In re George Walsh Chevrolet, Inc.*, 118 B.R. 99, 101-02 (Bankr. E.D. Mo. 1990).

[151] *In re Exaeris, Inc.*, 380 B.R. at 744-47 (denying motion to approve asset sale where the debtor failed to present evidence of efforts to market assets to parties other than the proposed insider-purchaser).

on expert valuation testimony, argued that the sale price generated by this auction process was too low. But the bankruptcy court approved the sale at the auction price, concluding that "absent a showing that there has been a clear market failure, the behavior of the marketplace is the best indicator of enterprise value."[152] If a sale is to an insider of the debtor, the court will impose a greater level of scrutiny on the sale procedures and the price.[153]

In practice, section 363 sales often involve essentially two auctions. The first is the auction to determine the stalking-horse bidder, which frequently occurs prior to the bankruptcy filing, although the debtor can decide to launch a sale process at any time in its chapter 11 case. The second is a bankruptcy court supervised auction, in which topping bids are solicited.

As with all bankruptcy matters, the likelihood of judicial approval of a sale increases if the sale is supported by secured creditors, as well as the official committee of unsecured creditors, and little or no opposition from other parties in interest emerges. It is, therefore, extremely important for a buyer to attempt to resolve the concerns of major creditors and other constituencies when structuring a proposed asset sale. It is also common for the creditors' committee to demand a formal role in the auction process and for the auction rules to so provide.

b. *The* Sub Rosa *Plan Doctrine*

A sale outside the ordinary course of business, particularly one involving all or substantially all of a debtor's assets, can also raise the issue of whether the sale is actually a "disguised plan of reorganization" or a "*sub rosa*" plan. Because the Bankruptcy Code's requirements for confirmation of a plan are specially designed to ensure both the democratic participation by, and fair treatment of, creditors, a sale of assets under section 363(b), which does not impose such requirements, cannot serve as a substitute for a chapter 11 plan.[154] Accordingly, an element in

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[152] *In re Bos. Generating, LLC*, 440 B.R. at 325; *see also In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 149 (3d Cir. 1986) (noting that "an auction may be sufficient to establish that one has paid 'value' for the assets of a bankrupt"); *In re Pursuit Capital Mgmt., LLC*, 874 F.3d 124, 136 (3d Cir. 2017) (explaining that "a competitive auction strongly indicates that a purchaser has paid appropriate value for estate assets").

[153] *In re W.A. Mallory Co.*, 214 B.R. 834, 837 (Bankr. E.D. Va. 1995) (proposed sales to insiders must face higher scrutiny). *See also* Part III.A.1.c.

[154] Under the Bankruptcy Code, even where a sale of all assets is accomplished via a section 363 sale, a plan may still be needed to distribute the proceeds from the sale to the appropriate stakeholders.

the bankruptcy court's assessment of transactions outside the ordinary course of business is whether the transaction infringes upon creditor priorities and other protections afforded by the plan confirmation process. A sale will not be approved if it constitutes a *sub rosa* (secret) chapter 11 plan, *i.e.*, one that dictates the distributions to creditors and other elements of a chapter 11 plan.[155]

Although the *sub rosa* (or *Braniff*) plan objection has been ubiquitous in bankruptcy litigation, it is rarely successful. Generally speaking, a straightforward sale of an asset in exchange for fixed consideration, without specification of how the sale proceeds will be distributed, is not at risk of disapproval as a *sub rosa* plan. Similarly, a sale transaction pursuant to which the bulk of the proceeds would be distributed to the secured lenders, with any remaining proceeds to be distributed in accordance with a plan, has been found not to run afoul of the *sub rosa* plan doctrine.[156]

c. *The Good Faith Requirement*

While there is no express requirement in section 363(b) that the court find the purchaser acted in good faith, it is in the interest of the buyer to procure such a finding in the sale order, to limit appellate review of the sale. Under section 363(m), so long as the acquisition is found to be in good faith (and the sale order is not stayed pending appeal), a reversal or modification of the sale order on appeal will not affect the validity of the sale.[157] Section 363(m) thus significantly limits appellate review of a consummated sale, helping to maximize the sale price by ensuring finality to bidders.[158]

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[155] *See In re Braniff Airways*, 700 F.2d 935 (5th Cir. 1983).

[156] *See In re Bos. Generating, LLC*, 440 B.R. at 331 ("Here, the proposed sale of the Debtors' assets is not a 'sub rosa' plan of reorganization. The Debtors' assets are simply being sold; the First Lien Lenders will receive most of the proceeds in accordance with their lien priority; and remaining consideration will be subsequently distributed under a plan.").

[157] Prashant M. Rai, *The Cloak of Good Faith: Protecting Bankruptcy Sales from Appellate Review*, 2017 NO. 4 NORTON BANKR. L. ADVISER 1, 5 (Apr. 2017) ("Section 363(m) establishes that a court exercising appellate jurisdiction over a bankruptcy court order approving a 363 sale may not invalidate the sale if the appellant failed to obtain a stay and the buyer purchased the debtor's assets in good faith. Stated differently, if the appellant fails to obtain a stay of the sale order pending appeal, the sale order is 'statutorily moot' on appeal as to all issues other than whether the buyer purchased the assets in good faith.").

[158] *See Official Comm. of Unsecured Creditors* v. *Anderson Senior Living Prop., LLC (In re Nashville Sr. Living, LLC)*, 620 F.3d 584, 594 (6th Cir. 2010); *Hower* v. *Molding Sys. Eng'g*

Courts generally apply a heightened standard of review to transactions in which a proposed purchaser is an insider or fiduciary of the debtor.[159] The "good faith" analysis focuses primarily on whether an insider has received any special treatment in connection with a section 363 sale.[160]

Where one or more members of the debtor's management is the prospective purchaser, there is a risk that other bidders, believing management has a lock, will be less likely to bid. Management can also deprive bidders of information or access to personnel, or threaten to leave if their deal is not accepted.[161] A recent example where an insider who was both management and equity was able to demonstrate its good faith and prevail on a bid occurred in *In re Sears Holdings Corporation.* There, the Bankruptcy Court for the Southern District of New York approved a sale of most of the company's ongoing assets to ESL Investments, a hedge fund run by the company's former CEO and Chairman, and a 49% equity owner, over the vigorous opposition of the creditors' committee.[162] The court held that a formal auction was not required, but that an inquiry into the sale process was "clearly warranted, especially where the sale is to an insider."[163] After an extensive evidentiary hearing, the court found that ESL had not controlled the sale process, having entirely removed itself from management and the Board as of the filing and been replaced by an independent committee of the

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Corp., 445 F.3d 935, 938 (7th Cir. 2006); *Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 387 (2d Cir. 1997); *In re GSC, Inc.*, 453 B.R. 132, 169 (Bankr. S.D.N.Y. 2011).

[159] If the debtor is a corporation, the Bankruptcy Code defines an "insider" as including any (1) director, officer, general partner or person in control of the corporation or a relative of such person, (2) a partnership in which the debtor is a general partner, or (3) an affiliate of the debtor (which would include a shareholder holding greater than 20% of the voting stock.) *See* 11 U.S.C. §§ 101(2), (31).

[160] *See In re Indus. Valley Refrigeration & Air Conditioning Supplies, Inc.*, 77 B.R. 15, 21 (Bankr. E.D. Pa. 1987).

[161] One way that debtors can demonstrate good faith when facing a 363 sale bid from an insider is by implementing internal screening procedures to prevent insider bidders from obtaining an information advantage.

[162] *See* Transcript of Feb. 7, 2019 Hearing, *In re Sears Holdings Corp.*, No. 18-23538-rdd, at 217 (Bankr. S.D.N.Y. Feb. 11, 2019), ECF No. 2886.

[163] *Id.* at 217.

Board represented by independent counsel and financial advisors.[164] Based on this record, the court found it "clear" that "ESL conducted itself . . . in good faith, for purposes of § 363(m) of the Bankruptcy Code."[165]

However, there have been instances where bids from insiders have been rejected because of an inability to demonstrate good faith. *In re Abbotts Dairies of Pennsylvania*,[166] the debtor entered into an arrangement with the prospective purchaser pursuant to which the CEO of the debtor would become a consultant to the purchaser during the bankruptcy process and then serve as an executive of the purchaser for five years after the completion of the transaction. The prospective purchaser also agreed to waive any claims against the CEO. While the bankruptcy court approved the sale without addressing the purchaser's good faith, it was argued on appeal that the CEO, in return for the employment offer, had contrived an "emergency" to justify the section 363 sale and manipulated the timing of the bankruptcy filing to preclude truly competitive bidding. The Third Circuit Court of Appeals reversed the bankruptcy court's approval of the sale, holding that, in approving a sale of assets under section 363, the bankruptcy court must make a finding as to whether the prospective purchaser is acting in good faith. It also found that the appellants' allegations would constitute collusion with an insider and would not be consistent with a finding of good faith.[167]

Similarly, in *In re Bidermann Industries U.S.A., Inc.*,[168] the bankruptcy court rejected a proposed leveraged buyout of the debtor for lack of good faith due to conflicts of interest and self-dealing between the proposed purchaser and the debtor's management. The proposed transaction contemplated an acquisition of the debtor by a private equity investor and a consulting firm hired by the debtor in its bankruptcy. The debtor agreed not to solicit any other proposals or offers; the consultant was to receive a minority interest in the new company "financed in part by a success fee which [the private equity investor] will pay"; and an officer of the consultant was to act as the CEO of the new company and chairman of the

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[164] *Id.* at 225-6. The court found that these third-party committees were "truly independent," pointing to "their rejection of numerous proposals by ESL and heated and lengthy negotiations with ESL," as well as their independent representation. *Id.* at 226.

[165] *Id.* at 230.

[166] 788 F.2d 143 (3d Cir. 1986).

[167] *See id.* at 148-50.

[168] 203 B.R. 547 (Bankr. S.D.N.Y. 1997).

board.[169] None of the negotiations were conducted with the assistance of an investment bank or an independent financial advisor to "test the marketplace for other expressions of interest," a fact which the court found "astounding."[170] Rejecting the arrangement, the court stated that the consultant and the majority shareholder had "done little to ensure the integrity of this process because they [were] motivated by the possibility of personal gain."[171]

While the lengths to which it was necessary to go in *Sears* to secure approval of a sale to an insider may not be required in every case, the procedures followed there provide a useful model. And certainly in any case where a 363 sale involves an insider,[172] the parties should be sure to disclose fully to the court and creditors the relationship between the buyer and the seller, the nature and quality of the negotiation and marketing processes, and how the debtor determined that the price was fair and reasonable.

d. *Prohibition on Collusive Bidding*

The prohibition on collusive bidding in section 363(n) of the Bankruptcy Code is another important component of the good faith analysis, although it is an issue on which the courts have provided only limited guidance.[173] Section 363(n) permits the bankruptcy court to decline to approve a sale of assets where "the sale price was controlled by an agreement among potential bidders at such sale."[174] It also permits an approved sale to be avoided, or for damages to be obtained from a

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[169] *Id.* at 549-50.

[170] *Id.* at 551.

[171] *Id.* at 553.

[172] See Part IV.D.2.a below for a discussion of recent case law development concerning the definition of an "insider" under the Bankruptcy Code.

[173] *See generally* Jason Binford, *Collusion Confusion: Where Do Courts Draw the Lines in Applying Bankruptcy Code Section 363(n)?*, 24 EMORY BANKR. DEV. J. 41 (2008).

[174] 11 U.S.C. § 363(n). Such agreement need not be reduced to a written instrument and, in certain cases, has been inferred from the circumstances. *See Sunnyside Land, LLC* v. *Sims (In re Sunnyside Timber, LLC)*, 413 B.R. 352, 363 (Bankr. W.D. La. 2009) ("An agreement proscribed by section 363(n) need not be an explicit written agreement, but may be an oral agreement to collude or an agreement inferred from the behavior of the parties or the circumstances."), *leave to appeal denied*, 425 B.R. 284 (W.D. La. 2010).

bidder, if a collusive agreement among bidders deprived the estate of value.[175] Finally, if the purchaser acted in willful disregard of section 363(n), the court can order punitive damages. Although to date no reported decision has done so, in practice, the potential for punitive damages appears to have a strong deterrent effect.

While it is often difficult to draw the line between improper collusion and benign team bidding, some distinctions are clear. Section 363(n) prohibits a potential bidder from agreeing not to bid in order to permit another bidder to purchase assets at a discount with an agreement to divide the assets or receive a cash payment after the auction.[176] For such conduct to violate section 363(n), there must be an intention to control the price of the asset, and the purportedly collusive action must "control" rather than incidentally affect the sale price.[177] Ultimately, the distinction between collaboration and collusion may be difficult to delineate and may turn on fact-intensive matters, such as the parties' motivation in joining together in a bid.[178]

In practice, potential buyers often bid jointly, and it is possible for collaboration to be beneficial to the debtor—especially when a pool of assets is too large or diverse to be of interest to any single bidder and a bid for only part of the assets would leave the estate with orphaned remains of lesser value. Joint bidding may even be necessary for certain transactions to occur at all. There are also situations, however, where joint bidding deprives the estate of the greater value that could be generated by competitive bidding.

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[175] *See id.*; *see also Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 391 (2d Cir. 1997); *In re Intermagnetics Am., Inc.*, 926 F.2d 912, 917 (9th Cir. 1991).

[176] *See, e.g.*, *Ramsay* v. *Vogel*, 970 F.2d 471, 474 (8th Cir. 1992) (bidding agreement by which two highest bidders split increment between themselves was "precisely the evil Congress intended to deal with in § 363(n)"); *In re Stroud Ford, Inc.*, 163 B.R. 730, 733 (Bankr. M.D. Pa. 1993) (potential bidders violated section 363(n) by agreeing to withdraw their bid in exchange for cash).

[177] *See Lone Star Indus., Inc.* v. *Compania Naviera Perez Companc, S.A.C.F.I.M.F.A., Sudacia, S.A. (In re N.Y. Trap Rock Corp.)*, 42 F.3d 747, 752-53 (2d Cir. 1994) (noting that "[t]he influence on the sale price must be an intended objective of the agreement, and not merely an unintended consequence," but finding that collusion claim could be sustained where bidder dropped out in exchange for sharing of marginal bid value).

[178] *See In re Edwards*, 228 B.R. 552, 565 (Bankr. E.D. Pa. 1998) (agreement between joint bidders not intended to control price).

As there are remarkably few cases applying section 363(n), there is little guidance on how courts will react to joint bidder situations, and purchasers should act cautiously when entering into arrangements with other bidders in connection with a possible asset purchase.[179] Generally, the practice is to make disclosures to the debtor, secured lenders, and the creditors' committee, and not to the court, although the better practice might be to do so. Critically, the group should avoid any agreement under which a member plans to withdraw or withhold its bid with the expectation that it will nonetheless share in the assets sold.[180] Factors likely to be considered by a court include whether: (a) the members of the bidding group have the financial ability to bid individually for the entire business, (b) the members of the bidding group only have a strategic interest in select assets regardless of financial capability, (c) the group's bid is higher than what any individual bid by the members would have been, (d) there are other competitors bidding (*i.e.*, does the group consist of all of the parties interested in the assets?), and (e) the group timely communicated its desire and rationale for bidding together to the relevant parties.[181] As a practical matter, it is often the debtor that will define the scope of acceptable behavior for a given auction—in the bid procedures order it proposes to the court. To limit the opportunity for collusion, it is common for auction rules to require the debtor's permission to share confidential information or form bidding groups.

The 2011 sale of Nortel Network's portfolio of over 6,000 mobile telecommunications patents through a section 363 sale is a prime example of the potential benefit to the estate of collaborative bidding and the use of appropriate protections against collusion. Because intellectual property portfolios are often held by consortia whose members cross-license technology to one another, the bidding procedures for the auction expressly contemplated group bids, but required each bidder in a group to disclose to the debtor and other bidders its

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[179] *See, e.g.*, *In re Colony Hill Assocs.*, 111 F.3d 269, 277 (2d Cir. 1997) ("Many courts ruling on challenges to a purchaser's good faith status have focused on whether the acts about which the appellant complained were disclosed to the bankruptcy court. . . . Although full disclosure to the bankruptcy court may not always neutralize conduct that would otherwise constitute bad faith, disclosure should certainly weigh heavily in a bankruptcy court's decision on that issue.").

[180] *See Boyer* v. *Gildea*, 374 B.R. 645, 660 (N.D. Ind. 2007) (in deciding whether the trustee put forth sufficient evidence for a claim under section 363(n), the court noted that a reasonable trier of fact could infer collusion from the fact that one potential bidder did not submit a bid but purchased the assets from the highest bidder shortly after the sale).

[181] *See* Ilene Knable Gotts & Franco Castelli, *Special Antitrust Issues Raised by Private Equity Minority Investments*, The Threshold, Vol. III, No. 3 (Summer 2008), at 15-22.

relationship to the other group members and to affirm that it had not engaged in collusive behavior. As the bids increased over the course of the auction, individual bidders dropped out, only to resurface as part of a group.[182] Ultimately, an ad hoc consortium of industry heavyweights that included Apple, Microsoft, Research in Motion, Sony and Ericsson won with a bid of $4.5 billion—a price higher, it seemed, than any member of the group was willing to pay on its own—prevailing over a competing bidding group that included Google and Intel.

2. Benefits and Risks of Using Section 363

a. *Benefits of Using Section 363*

(i) Speed

Plan confirmation is a complex process that generally requires a significant amount of time. Even when a plan is not contested, parties need time to build consensus and adhere to the procedural formalities surrounding plan presentation and voting. If a plan is nonconsensual, parties require additional time to litigate objections and renegotiate if objections prove well-founded. By contrast, a section 363 sale is designed to be expeditious. Although the marketing process and auction required before a significant asset of a bankrupt estate is sold may take some time, section 363 generally permits buyers to acquire assets without substantial delay.

For companies facing severe liquidity or business challenges, one common approach is to negotiate a sale with a stalking-horse bidder outside of bankruptcy. This allows the debtor to file for bankruptcy with a stalking-horse bid and a set of bidding procedures in hand. The advantage of this approach to the debtor is that it permits the company's management to conduct the initial auction process free of the constraints on its independence and the expense of the inevitable creditor involvement that will exist during bankruptcy. It is typical for the company to negotiate a form of asset purchase agreement, bidding procedures and a break-up fee with the stalking-horse bidder, discussed in detail in Part III.A.4 of this outline. The company will then file bankruptcy and seek approval of the bidding procedures, and a second auction will take place to determine the highest and best bid. Generally, the stalking-horse bidder has a right to terminate the asset purchase agreement if a court order approving bidding procedures and setting an

[182] *In re Nortel Networks Inc.*, 2011 WL 4831218, at *5 (Bankr. D. Del. July 11, 2011).

auction date is not entered shortly after the bankruptcy commences. A typical period of time from approval of the bidding procedures to auction is 30 to 60 days.[183] However, as an unduly streamlined process may deprive the company of the value that could come from other bids, there can be pressure from the creditors or even the court to extend the deadline.[184] In order to participate in the process and gain access to confidential diligence materials, potential bidders may be required to demonstrate their financial wherewithal to make a bid, disclose any special conditions their bid will involve (such as approval by the bidder's shareholders, antitrust clearance, lender consents, etc.) and provide an indicative price range.

The auction of substantially all of the assets of The Weinstein Company is illustrative of the speedy timetable on which a section 363 sale may run. The Weinstein Company filed for bankruptcy on March 19, 2018, with a stalking-horse agreement with Lantern Capital already signed.[185] Bidding procedures were approved on April 6, 2018,[186] with a bid deadline of May 1, 2018. The winning bidder was the stalking horse, whose bid was approved on May 8, 2018.[187] Thus, from start to finish, The Weinstein Company sold substantially all of its assets in bankruptcy in 50 days. There are numerous other examples of similarly quick auctions.

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[183] Even where a robust pre-bankruptcy shopping process has occurred, it is customary for the postpetition marketing process to last at least 30 days to ascertain if there are any other bids forthcoming. Thus, apart from truly extraordinary emergencies—such as the Lehman Brothers case (where the broker-dealer subsidiary was sold within five days of the parent's bankruptcy filing) or the auto company bankruptcies (such as Chrysler, where the bankruptcy court entered the sale order within one month of the filing)—a rapid sale is likely to occur only where the assets have been thoroughly auctioned prior to filing, and nothing remains to be done but seek bankruptcy court approval, with any objectors to the sale having the opportunity to be heard.

[184] *See, e.g.*, *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 61 (Bankr. D. Del. 2014) (noting, in denying secured creditor's right to credit bid, that secured creditor "insisted on an unfair process, *i.e.*, a hurried process").

[185] *See* Debtors' Motion for Entry of Orders Approving Bidding Procedures for Sale of Substantially All of the Debtors' Assets, *In re The Weinstein Co. Holdings LLC*, No. 18-10601 (Bankr. D. Del. Mar. 19, 2018), ECF No. 8.

[186] *See* Order (I)(A) Approving Bidding Procedures for Sale of Substantially All of the Debtors' Assets, *In re The Weinstein Co. Holdings LLC*, No. 18-10601 (Bankr. D. Del. Apr, 6, 2018), ECF No. 190.

[187] *See* Order (I) Authorizing the Sale of All or Substantially All of the Debtors' Assets, *In re The Weinstein Co. Holdings LLC*, No. 18-10601 (Bankr. D. Del. May, 9, 2018), ECF No. 846.

Given the potential for such a truncated process, a buyer who wants to participate in a bankruptcy sale—especially one that has not participated in the bidding round that often occurs pre-bankruptcy to identify potential stalking-horse bidders, and is therefore behind the curve in terms of information—must be prepared to mobilize the resources necessary to act very quickly. A variety of financial and legal issues will need to be addressed. In addition to the matters that must be considered in any acquisition—such as value, financing, operational challenges, labor matters, management issues, environmental risks, major contracts and leases, and, particularly in the case of retailers, the seller's owned and leased real estate portfolio—an acquisition in bankruptcy presents the opportunity to reshape the debtor by leaving behind unwanted contracts or operations. A buyer also must stand ready to object to proposed auction procedures, garner the support of key constituents, and, if necessary, litigate the merits of a proposed deal, all on an expedited timeline.

Where circumstances require a significant lag between signing and closing, such as where regulatory or other approvals are required, there may be a need for an interim operating arrangement or transitional services agreement, which itself requires court approval. Tools commonly used include a management agreement, whereby the acquiror takes over the operations pursuant to a contract with the debtor, and funding mechanisms, whereby the acquiror assumes responsibility for the profits and losses of operating the business between the time the sale is approved and the closing. Such arrangements are intended to make the estate whole for the cost of doing a transaction with an acquiror that is incapable of closing immediately.

(ii) Ability to "Cherry Pick" Assets

A purchaser under section 363 of substantially all or a portion of a debtor's assets often is given the flexibility to cherry pick from among the debtor's assets for a specified period of time, and sometimes even post-closing. This can be a helpful mechanism given the limited amount of time bankruptcy sales generally afford for due diligence. For example, the buyers in the *Pillowtex* and *Refco* chapter 11 cases negotiated for the right to pick through the company's assets for several months after closing and take whatever assets they chose without paying additional consideration (but without a reduction in the purchase price if they declined to take certain assets). Assets that can be subject to such cherrypicking can be of any type, but they most frequently include leases and executory contracts that often are not assignable outside bankruptcy and can either be rejected by the debtor or assumed and assigned to the buyer (discussed in

Part III.B.8 of this outline). Typically, the buyer will direct which "executory" contracts and leases will be assumed and assigned following the sale.[188] This process allows the buyer the opportunity to conduct post-closing diligence and also to seek to renegotiate contracts with the debtor's landlords and counterparties. Technically, under the Bankruptcy Code, contracts must be either assumed or rejected (*i.e.*, there is no renegotiation option); however, the power of a debtor to reject a contract that is economically unfavorable creates strong leverage with which to compel a counterparty to renegotiate. For example, in the *ClearEdge Power* chapter 11 case, the buyer was able to use the possibility that it would not assume various customer contracts to obtain substantially increased servicing fees.

It is not uncommon for a debtor to require the buyer to pay the costs of curing any defaults under the leases and contracts that are to be assigned to it post-closing, or even to cover the rejection costs associated with leases and contracts the purchaser chooses not to take (although inasmuch as rejection costs are prepetition claims payable in discounted "bankruptcy dollars," calculation of the purchaser's liability is difficult). A buyer with substantial leverage, however, may be able to avoid those costs. In *Refco*, for example, the purchaser of the debtor's global commodities trading business was able to decide, months after the fact and after conducting significant due diligence for which there was no time prior to the acquisition, that it preferred not to take certain potentially money-losing foreign offices and also was able to require the debtor to assume and assign to it the leases and contracts it designated over an 18-month post-closing period, with the debtor paying the costs of either cure or rejection. In *ClearEdge Power*, the buyer was able to impose a contract-by-contract cap on its exposure to cure costs, leaving the debtors responsible for the payment of all cure costs in excess of the cap.

Prospective purchasers' differing intentions with respect to assumption or rejection of leases and executory contracts, or other assets that might be cherry picked, can complicate the auction process, making it difficult to compare the value of competing bids. In *Refco*, the debtor treated bidders willing to take on its London business as if the value of their bids was more than $30 million greater than their face amount. In the *Cable and Wireless* chapter 11 case, bids were evaluated on the basis of a projected cost of a rejection claim, with bids that

[188] *See, e.g.*, *In re United Retail Grp., Inc.*, No. 12-10405 (SMB) (Bankr. S.D.N.Y. Aug. 10, 2012) (authorizing the winning bidder in the 363 sale to continue to direct which leases it would assume for 90 days following entry of the sale order).

contemplated rejections being assessed a penalty for valuation purposes (because the resulting rejection damages would dilute the recovery of existing unsecured claims). Further complications can result from creditor opposition to the creation of rejection damages claims that would share in their recovery. A prospective acquiror, whether under section 363 or in the plan context, should carefully consider these factors in structuring bids and competing against other bidders.

Another form of cherrypicking that has been permitted in certain retail bankruptcies is the sale of "designation rights." This allows the purchaser to market the debtor's owned real estate, leases or intellectual property (including inbound license agreements) for a fixed period of time and, if such assets are sold, to keep all or a portion of the sale proceeds without ever having to take direct title. The ability to avoid taking title can be of particular importance if environmental liabilities are a concern. Leases and other agreements that are not sold will be rejected by the debtor, at no additional cost to the purchaser.

(iii) Protections that Can Be Obtained from Bankruptcy Court's Approval Order

(A) Finding of Good Faith—Section 363(m) Protection from Reversal on Appeal

Under section 363(m) of the Bankruptcy Code, once an asset sale is approved, the validity of that sale to a good-faith buyer is not subject to reversal or modification on appeal unless the party challenging the sale can obtain a stay pending appeal. Stays are difficult to obtain, and even if granted will require the posting of a bond, which may be prohibitively expensive, to protect against any damages that could result from the delay caused by the stay. The purchaser therefore gets significant protection from a finding of good faith, making it critical that a factual record be made at the sale hearing and that the court make an explicit finding of good faith in its sale approval order.[189]

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[189] Some jurisdictions require that a court make an affirmative finding of good faith when approving a section 363 sale. *See, e.g.*, *In re Abbotts Dairies of Pa., Inc.*, 788 F.2d 143, 149-50 (3d Cir. 1986). In other jurisdictions, however, courts may consider good faith either at the approval stage or when a section 363 sale is appealed pursuant to section 363(m). *See In re Thomas*, 287 B.R. 782, 785 (B.A.P. 9th Cir. 2002) (noting that a finding of "good faith" is "not an essential element" of approving a sale under section 363(b)); *accord In re Zinke*, 97 B.R. 155, 156 (Bankr. E.D.N.Y. 1989). Purchasers in a section 363 sale should, at a minimum, try to obtain an explicit section 363(m) finding in the bankruptcy court's order approving the sale. Creating a record at the sale hearing to support such a finding will go even further to ensure that the protections of section 363(m) apply. *See Crowder* v. *Given (In re Crowder)*, 314 B.R. 445, 447

Courts have generally interpreted section 363(m) broadly to preclude reversal or modification on appeal of nearly all aspects of the sale order.[190] The Second Circuit, which includes New York, has held that an appellate court has no jurisdiction to review any portion of a bankruptcy court's sale order, except to hear challenges to the "good faith" aspect of the sale, or possibly challenges to provisions of the order "that are so divorced from the overall transaction" that they "would have affected none of the considerations on which the purchaser relied."[191] The Eighth Circuit Court of Appeals, in *Asset Based Resource Group, LLC* v. *U.S. Trustee (In re Polaroid Corp.)*, concluded that section 363(m) applied not only to provisions in a sale order authorizing the transfer of title, but also to a provision extinguishing interests in the property being sold.[192] The Third

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(B.A.P. 10th Cir. 2004) ("While the court failed to make detailed findings supporting its finding of good faith under § 363(m), the conclusion is amply supported by the record."); *see also In re Fitzgerald*, 428 B.R. 872, 881 (B.A.P. 9th Cir. 2010) ("The boilerplate 'good faith' finding in the Sale Order does not suffice under section 363(m), and the bankruptcy court should not have signed such an order without an evidentiary foundation." (citing *T.C. Investors* v. *Joseph (In re M Capital Corp.)*, 290 B.R. 743, 752 (B.A.P. 9th Cir. 2003))); *In re Tempo Tech. Corp.*, 202 B.R. 363, 367 (D. Del. 1996) ("[W]here the good faith of the purchaser is at issue, the district court is required to review the bankruptcy court's finding of good faith before dismissing any subsequent appeal as . . . moot under section 363(m).").

[190] *But see Clear Channel Outdoor, Inc.* v. *Knupfer (In re PW, LLC)*, 391 B.R. 25, 35-36 (B.A.P. 9th Cir. 2008) (protections of section 363(m) limited to transfer of the asset to first lienholder who won auction and did not preclude reversal of portion of sale order extinguishing second lien). *Clear Channel* is an outlier and has generally not been followed. *See, e.g.*, *In re Mortgs. Ltd.*, 590 F. App'x 671, 673-74 (9th Cir. 2014) ("Moreover, we are not bound by, nor are we required to defer to, the Bankruptcy Appellate Panel's decision in [*Clear Channel*]. . . ."); *Nashville Senior Living*, 407 B.R. at 231 (describing *Clear Channel* as "an aberration in well-settled bankruptcy jurisprudence applying § 363(m)" and observing that "the overwhelming weight of authority disagrees with [*Clear Channel*'s] holding"); *Asset Based Res. Grp., LLC* v. *U.S. Tr. (In re Polaroid Corp.)*, 611 F.3d 438, 440 (8th Cir. 2010) (expressly disagreeing with *Clear Channel*).

[191] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 248-49 (2d Cir. 2010); *see also, e.g.*, *Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 392-93 (2d Cir. 1997) (because section 363(m) permits only consideration of good faith, an appellate court may not review whether property sold was in fact property of bankrupt estate). *But see Trinity 83 Dev., LLC* v. *ColFin Midwest Funding, LLC*, No. 18-2117, 2019 WL 987902 (7th Cir. 2019) (holding that section 363(m) is not a jurisdictional bar, but is a valid defense to an appeal, and that a challenge to the disposition of sale proceeds was not barred by section 363(m)).

[192] 612 F.3d at 1017, 1019 n.2.

Circuit has similarly construed section 363(m) broadly in order to "promote the finality of sales."[193]

(B) Insulation from Fraudulent Transfer Challenge

The order approving a section 363 sale should also include a specific finding that the consideration paid for the debtor's assets was fair and reasonable. This finding should protect a purchaser from a subsequent claim that the sale constituted a fraudulent transfer—*i.e.*, a transfer by an insolvent or undercapitalized debtor for which the debtor did not receive adequate consideration. In contrast, when sales are completed with a financially distressed seller outside of bankruptcy, and the seller files for bankruptcy court protection after the sale is completed, an acquiror can find itself subject to legal challenges to the reasonableness of the sale process and the price paid, as was discussed in Part I.B.1.a of this outline.

(C) Successor Liability Issues: Purchasing Assets "Free and Clear"

Another advantage of a sale in bankruptcy is the ability to obtain a court order cleansing the purchased assets of "interests" in the property. Section 363(f) of the Bankruptcy Code authorizes the sale of assets "free and clear" of any interest, with such interests to attach to the proceeds of the sale instead. Although the protections afforded by such an order are not absolute, a section 363 order can limit significantly any liabilities that a purchaser may be deemed to assume in an acquisition.

In an acquisition of the assets of a business outside of bankruptcy, a buyer typically will agree to assume some of the seller's liabilities, such as unpaid trade debts incurred in the ordinary course of the seller's business, but no buyer wants to incur additional liabilities involuntarily. Whenever assets are transferred and the transferor ceases to exist, however, there is some risk that the transferee will succeed to certain liabilities of its predecessor, such as debts or tort claims, by operation of law—so-called "successor liability."

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[193] *In re Pursuit Capital Mgmt.*, 874 F.3d 124, 133-34, 139 (3d Cir. 2017); *see also Official Comms. of Unsecured Creditors* v. *Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)*, 407 B.R. 222, 231 (B.A.P. 6th Cir. 2009).

While a sale in bankruptcy does not *per se* bar the assertion against an asset purchaser of any and all claims against the seller, it does offer substantial protection for a buyer from involuntarily becoming responsible for the seller's liabilities. Specifically, section 363(f) insulates purchasers of estate property, permitting under certain circumstances the acquisition of property from the debtor "free and clear of any interest in such property" and relegating holders of "interests" to a recovery from the sale proceeds. Thus, section 363 is structured to encourage nervous bidders to purchase assets in bankruptcy.[194]

(i) Scope of "Interests" Subject to Section 363(f)

Although the statutory language only speaks in terms of a sale free and clear of "interests," courts generally interpret that term broadly to include not only liens and secured claims, but also other kinds of claims, such as general unsecured claims with a connection to the acquired property.

In re Trans World Airlines, Inc.[195] is a leading case holding that the type of interest in property that may be extinguished through section 363(f) should be read quite broadly. Relying on section 363(f)(5) (discussed below)—and the fact that the claim could be satisfied via the payment of money following the sale—the court ruled that assets of the debtor can be sold free and clear of general unsecured claims attributable to their prior use.[196] This interpretation enables a broad spectrum of unsecured claims to be barred by a sale under section 363, so that a well-drafted sale order entered pursuant to this section expressly protects a buyer from any liability for claims against the seller that the buyer has not agreed

[194] *See Olson* v. *Frederico (In re Grunman Olson Indus.)*, 445 B.R. 243, 249 (Bankr. D. Del 2011) ("Extending the 'free and clear' provisions in this manner serves two important bankruptcy policies. First, it preserves the priority scheme of the Bankruptcy Code and the principle of equality of distribution by preventing a plaintiff from asserting *in personam* successor liability against the buyer while leaving other creditors to satisfy their claims from the proceeds of the asset sale. . . . Second, it maximizes the value of the assets that are sold." (internal citations omitted)).

[195] 322 F.3d 283 (3d Cir. 2003).

[196] *Id.* at 290-91 (no buyer liability for employment discrimination claims); *see also In re Ormet Corp.*, 2014 WL 3542133, at *1 (Bankr. D. Del. July 17, 2014) (no buyer liability for claims under ERISA or Multiemployer Pension Plan Amendments Act of 1980); *see also In re Vertis Holdings, Inc.*, 536 B.R. 589, 636 (Bankr. D. Del. 2015) (no buyer liability for alleged tortious acts of the debtors that occurred prior to the asset sale).

to assume,[197] and has been accepted by most courts,[198] including the Second Circuit Court of Appeals and the Delaware bankruptcy courts.

(ii) The Five Triggers of Section 363(f) Protection

Section 363(f) allows a sale to be "free and clear" of interests if any one of five conditions is met. Each of the conditions, summarized below, may present traps for the unwary in any particular case. Consequently, any sale likely to implicate holders of significant "interests" in the assets requires careful assessment of how section 363(f) can be satisfied.

Section 363(f)(1) permits a trustee to sell property free and clear of any interests if applicable non-bankruptcy law permits such a sale. The relevant non-bankruptcy law often is state law, such as state property law,[199] or section 9-320(a) of the

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[197] *Compare In re Leckie Smokeless Coal Co.*, 99 F.3d 573, 582 (4th Cir. 1996) (lack of express statutory limitation on "interests" supported expansive reading), *cert. denied*, 520 U.S. 1118 (1997), *with In re Eveleth Mines, LLC*, 312 B.R. 634, 654 (Bankr. D. Minn. 2004) (criticizing the *Trans World Airlines* reading of "interest" and finding it inapplicable to state tax liability computed on basis of mining production), *rev'd on other grounds*, 318 B.R. 682 (B.A.P. 8th Cir. 2004). However, property cannot be sold free and clear of any legal defenses against claims to payment arising out of that property. *See IDEA Boardwalk, LLC* v. *Revel Entm't Grp., LLC (In re Revel AC Inc.)*, 909 F.3d 597, 604 (3d Cir. 2018) (citing *Folger Adam Sec., Inc.* v. *DeMatteis/MacGregor, JV*, 209 F.3d 252, 257, 258-64 (3d Cir. 2000)).

[198] The Second Circuit expressly adopted the *Trans World Airlines* approach in the Chrysler bankruptcy, agreeing that "the term 'any interest in property' encompasses those claims that arise from the property being sold," and thus approved a transaction where the "possibility of transferring assets free and clear of existing tort liability was a critical inducement to the Sale." *In re Chrysler LLC*, 576 F.3d 108, 126 (2d Cir. 2009) (citation and internal quotation marks omitted), *vacating as moot*, *Ind. State Police Pension Trust* v. *Chrysler LLC*, 558 U.S. 1087 (2009). The Second Circuit's opinion in the Chrysler bankruptcy was vacated on technical grounds, but has remained a source of guidance to courts in the Second Circuit, including on this issue. The Second Circuit has repeatedly indicated willingness to continue following the reasoning of *Trans World Airlines* and *Chrysler*. In *Douglas* v. *Stamco*, the court held that a tort claimant could not sue the purchaser of the debtor's property since permitting the claim to go forward "would be inconsistent with the Bankruptcy Code's priority scheme" and would have a "chilling effect" on buyers in bankruptcy sales. *See* 363 F. App'x 100, 102-03 (2d Cir. 2010); *see also Elliott* v. *Gen. Motors LLC (In re Motors Liquidation Co.)*, 829 F.3d 135, 155 n.23, 156 (2d Cir. 2016) (following *Chrysler* "as persuasive authority").

[199] *See, e.g.*, *In re Rose*, 113 B.R. 534, 538 (W.D. Mo. 1990) (holding that property could be sold free and clear of life estate interest under section 363(f)(1) as permitted by state law providing for sale of burdensome life estate); *In re Bridge Assocs. of Soho, Inc.*, 589 B.R. 512 (Bankr. E.D.N.Y.

Uniform Commercial Code, which permits buyers in the ordinary course of business to take goods free of security interests created by the seller. Buyers of certain types of interests in real property should be aware that assets generally may not be sold free and clear of covenants that "run with the land." Local property law typically does not permit the sale of property free and clear of covenants that run with the land; such property cannot therefore be disposed of through section 363(f)(1).[200] Such covenants are often implicated in the oil and gas industry under agreements such as joint operating, gathering, and participation agreements.[201]

Section 363(f)(2) allows a trustee to sell property free and clear of all interests such as liens if the parties holding the interests consent to the sale free of such interests. It is common for an intercreditor agreement to provide for the junior creditors' consent in advance to such transactions. In addition, where a credit agreement vests authority in a single agent to act on behalf of a group of lienholders, the agent's consent will bind even those individual lienholders that oppose the sale.[202]

Section 363(f)(3) provides that if property is sold for an amount greater than the aggregate value of all the liens on the property, it may be sold free and clear of all liens. There is a split of authority over whether the term "value" refers to the economic value of the liens or the face value of all claims held by creditors who hold a lien.[203] Defining "value" as face value means that collateral cannot be sold

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2018) (denying sale free and clear because debtor failed to show that state law would have allowed such a sale).

[200] *See, e.g.*, *Newco Energy* v. *Energytec Inc.*, 739 F.3d 215 (5th Cir. 2013).

[201] See Part III.B.8 for a discussion of such covenants in the context of rejection of executory contracts under section 365.

[202] *See In re GSC, Inc.*, 453 B.R. 132, 183 (Bankr. S.D.N.Y. 2011) ("Consent under section 363(f)(2) is . . . established where an agent for a group of lenders properly consents on behalf of all lenders."); *In re Chrysler LLC*, 405 B.R. 84, 101-03 (Bankr. S.D.N.Y. 2009) (all lenders deemed to have consented for section 363(f)(2) purposes where majority vote of lenders authorized single administrative agent to direct collateral trustee to consent to sale). *But see In re Flour City Bagels, LLC*, 557 B.R. 53, 85-86 (Bankr. W.D.N.Y. 2016) (denying sale free and clear in part because debtor did not have affirmative consent of all secured creditors).

[203] *Compare In re Beker Indus. Corp.*, 63 B.R. 474, 475-76 (Bankr. S.D.N.Y. 1986) ("value" means "actual value as determined by the Court, as distinguished from the amount of the lien"), *and In re Bos. Generating, LLC*, 440 B.R. 302, 332 (Bankr. S.D.N.Y. 2010) ("The 'value' of a lien is to be determined by reference to section 506(a)—that is, it is the amount by which the

free and clear under section 363(f)(3) unless lienholders are paid in full.[204] New York bankruptcy courts have interpreted section 363(f)(3) to refer to the economic value of liens, which allows sales to go forward even though creditors with liens on the assets are not paid in full.[205] In New York and other jurisdictions following the economic value approach, so long as an auction occurs, which will determine the economic value of the assets underlying the liens, asset sales can take place "free and clear" of liens.

Section 363(f)(4) permits a free-and-clear sale where the interest is "in bona fide dispute." This provision codifies long-established law allowing property to be sold free and clear of a disputed debt. However, it does not justify a free-and-clear sale when the dispute concerns tangential matters, such as the validity of covenants or the distribution of sale proceeds.[206] Rather, the provision permits a sale where the fundamental validity of a lien or other property interest is debatable, although it cannot be used as a mechanism to sell property that does not truly belong to the estate.[207]

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lienholder's claim is actually secured."), *with Clear Channel Outdoor, Inc.* v. *Knupfer (In re PW, LLC)*, 391 B.R. 25, 41 (B.A.P. 9th Cir. 2008) ("[Section] 363(f)(3) does not authorize the sale free and clear of a lienholder's interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold.").

[204] *See, e.g.*, *In re Nance Props., Inc.*, 2011 WL 5509325, at *4 (Bankr. E.D.N.C. Nov. 8, 2011) (denying motion to sell property free and clear of liens because the purchase price did not exceed the face amount of all liens against the property).

[205] *See, e.g.*, *In re Bos. Generating, LLC*, 440 B.R. 302, 332-33 (Bankr. S.D.N.Y. 2010) ("The 'value' of a lien is to be determined by reference to section 506(a)—that is, it is the amount by which the lienholder's claim is actually secured. . . . To hold otherwise would effectively mean that most section 363 sales of encumbered assets could no longer occur either (a) absent consent of all lienholders (including those demonstrably out of the money) or (b) unless the proceeds of the proposed sale were sufficient to pay the face amount of all secured claims in full. . . . As both a practical matter and a matter of statutory construction, that cannot be the case.").

[206] *See, e.g.*, *Mancuso* v. *Meadowbrook Mall Co. Ltd. P'ship (In re Rest. Assocs., L.L.C.)*, 2007 WL 951849, at *9 (N.D. W. Va. Mar. 28, 2007) (covenants); *Richardson* v. *Pitt Cty. (In re Stroud Wholesale, Inc.)*, 47 B.R. 999, 1002 (E.D.N.C. 1985) (proceeds), *aff'd*, 983 F.2d 1057 (4th Cir. 1986).

[207] *See, e.g.*, *In re Nicole Energy Servs.*, 385 B.R. 201, 229 (Bankr. S.D. Ohio 2008), *appeal dismissed*, 2008 WL 11352585 (S.D. Ohio Aug. 14, 2008); *In re Whitehall Jewelers Holdings, Inc.*, 2008 WL 2951974, at *4 (Bankr. D. Del. July 28, 2008) (consignors' ownership rights must be determined pre-sale).

Section 363(f)(5) permits a sale free and clear of interests when an interest holder "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." This subsection protects a purchaser from liability for unsecured claims that arose from operation of the purchased assets prior to the sale.[208]

However, due process concerns have led some courts to hold that a section 363 sale will not extinguish a purchaser's liability for certain claims arising from the purchased assets after the sale, including claims for injuries caused by defects in products manufactured before the bankruptcy.[209] For example, in *In re Grumman Olson Industries, Inc.*,[210] the court held that, since at the time of the 363 sale "there was no way for anyone to know that the [plaintiffs] ever would have a claim," it would deprive them of due process "to take away their right to seek redress . . . when they did not have notice or an opportunity to participate in the proceedings that resulted in that order."[211] As a result, the court ruled that the sale order did not extinguish the plaintiffs' claims for post-sale injuries even though they were caused by defective products that had been manufactured and sold before the bankruptcy. Similarly, in considering whether claims relating to the ignition switch defect in General Motors cars were barred by the order approving the sale of Old GM to New GM,[212] the Second Circuit Court of Appeals held that a sale order will bar successor liability claims only if the claims arose from prepetition conduct of the debtor and the claimant was *identifiable* by virtue of its relationship with the debtor.[213] Applying that test, the court concluded that the

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[208] *See, e.g., In re Trans World Airlines, Inc.*, 322 F.3d 283, 290 (3d Cir. 2003).

[209] *See Morgan Olson, LLC* v. *Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243, 254 (Bankr. S.D.N.Y. 2011) ("[F]or reasons of practicality or due process, or both, . . . a person injured after the sale (or confirmation) by a defective product manufactured and sold prior to the bankruptcy does not hold a 'claim' in the bankruptcy case and is not affected by either the § 363(f) sale order or the discharge under 11 U.S.C. § 1141(d)."), *aff'd*, 467 B.R. 694 (S.D.N.Y. 2012); *cf.* Part III.B.4.b (discussing due process limitations on discharge of future claims through chapter 11 plan process).

[210] 467 B.R. 694 (S.D.N.Y. 2012).

[211] *Id.* at 708.

[212] *In re Motors Liquidation Co.*, 829 F.3d 135 (2d Cir. 2016), *cert. denied*, 137 S. Ct. 1813 (2017).

[213] *Id.* at 156. Specifically, (1) the claims must (a) "flow from the debtor's ownership of the sold assets," and (b) arise from a prepetition right to payment or a right to payment that "resulted from

sale order could bar claims arising from the ignition switch defect that occurred prior to the closing of the sale,[214] but that it could not bar such claims if the holders had not received prior notice of the proposed sale (and hence had no opportunity to negotiate a consensual assumption by New GM of their claims).[215] The Second Circuit ruling thus illustrates the breadth of persons whose claims may be cut off by a sale order (at a minimum, claims held by persons who owned, rode in, or came in contact with a GM vehicle prepetition). But the ruling also reinforces the importance of notifying all those potentially affected by that cutoff. The notification requirement is critical whenever the debtor may be the subject of product liability or other long-tailed involuntary liabilities.

As to whether section 363(f)(5) similarly protects a purchaser from liability for *secured* claims, the conventional wisdom is that section 363(f)(5) allows a sale over the objection of a secured creditor whose claim will not be paid in full by the purchase price whenever release of the security could hypothetically be compelled, as in a foreclosure action by a senior lienholder, or in a "cramdown" by a debtor confirming a chapter 11 plan.[216] It should be noted, however, that the Ninth Circuit Bankruptcy Appellate Panel, in its 2008 decision in *Clear Channel*, reached a contrary result, finding that the possibility of cramdown did not satisfy the requirement that there be a legal or equitable proceeding that could compel the holder of an out-of-the-money security interest to release its liens.[217] At the time, the *Clear Channel* decision generated considerable concern, but nearly all subsequent cases—even those in the Ninth Circuit—have favored a somewhat

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pre-petition conduct fairly giving rise to the claim[s]," and (2) "some contact or relationship [must exist] between the debtor and the claimant such that the claimant is identifiable." *Id.*

[214] *Id*. at 157-58.

[215] *Id*. at 166.

[216] *See* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 AM. BANKR. L.J. 235, 252 (2002); Robert M. Zinman, *Precision in Statutory Drafting: The Qualitech Quagmire and the Sad History of § 365(h) of the Bankruptcy Code*, 38 J. MARSHALL L. REV. 97, 134-36 (2004).

[217] *See Clear Channel Outdoor, Inc.* v. *Knupfer (In re PW, LLC)*, 391 B.R. 25, 42-46 (B.A.P. 9th Cir. 2008) (finding that section 363(f)(5) requires that there be a legal or equitable proceeding in which a court could compel an interest holder to release its interest for payment of an amount that is less than the full value of the claim and that the cramdown procedure of section 1129(b)(2) does not meet that standard).

more expansive reading of the statute.[218] The bankruptcy court in *In re Jolan, Inc.*[219] noted that *Clear Channel* took a particularly narrow view of section 363(f)(5) because the parties in that case had not identified legal and equitable proceedings that would satisfy the provision's requirements, and because the court chose to limit its holding to the arguments presented by the parties.[220] The *Jolan* court then identified numerous "legal and equitable proceedings [under applicable state law] in which a junior lienholder could be compelled to accept a money satisfaction."[221]

Buyers should weigh carefully the risk of sale objections from undersecured creditors where the cash purchase price likely will not satisfy all lienholders' claims. On the other hand, it is probable that underwater liens subject to a customary intercreditor agreement will be deemed to have consented to the sale under section 363(f)(2), since typical intercreditor agreements include the consent of the junior lienholder to any sale approved by the senior lienholder, including by way of a credit bid. Thus, multi-tiered lien structures should not prove fatal to section 363 sales.

b. *Risks and Disadvantages of Using Section 363*

(i) Public Auction Generally Required

Buying assets in a bankruptcy cannot be done quietly. To meet the requirements of section 363, the debtor must publicly file an asset purchase agreement and will generally be required to conduct a robust public auction process under which all parties in interest, including all creditors, receive adequate notice of the auction and the applicable deadlines and procedures. All stakeholders, including the unsecured creditors' committee and all contract counterparties, can review the asset purchase agreement and object to its terms. If there is a stalking-horse bid, stakeholders must first be given the opportunity to object to any deal-protection measures to be provided to the stalking horse. By contrast, companies operating

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[218] *See, e.g.*, *In re Bos. Generating, LLC*, 440 B.R. 302, 333 (Bankr. S.D.N.Y. 2010) (declining to follow *Clear Channel* and holding that "the existence of judicial and nonjudicial foreclosure and enforcement actions under state law can satisfy section 365(f)(5)"); *In re Jolan, Inc.*, 403 B.R. 866, 870 (Bankr. W.D. Wash. 2009).

[219] 403 B.R. at 866.

[220] *Id.* at 868-69.

[221] *Id.* at 869-70.

outside of bankruptcy and the would-be purchasers of their assets have the option to conduct a private sale.

The bankruptcy court process required under section 363 inevitably exposes any transaction, whether initially entered into inside or outside of bankruptcy, to the view of competing bidders, the target's creditors, regulators and other interested parties. Such exposure can make a transaction more expensive. Because of the possibility of unknown, third-party objection and interference, it also may create greater execution risk for both buyers and sellers than exists outside of bankruptcy.

(ii) Potential for Delay

Although bankruptcy sales sometimes happen very quickly, the bankruptcy process generally is known more for its delays than for its expeditiousness. Generally, the Bankruptcy Rules require at least 21-days' notice of a proposed transaction to be provided to parties in interest, although the courts may shorten that notice period upon a showing of exigent circumstances.[222] If objections are lodged to a proposed sale, the sale can be further delayed while the parties seek to resolve the objections consensually or the court conducts a hearing and issues its decision.

The first source of delay may arise in connection with the request for approval of proposed bidding procedures. It is not uncommon for a creditors' committee or other parties in interest to object to aspects of the bidding procedures, asking the court to reject the bidder protections and/or slow down the sale timeline. The official creditors' committee is often interested in slowing down the timeline because (a) the committee is generally not formed until at least a week or two after the petition date, and may in fact need more time to review the bidding procedures and (b) they may believe a longer marketing process will yield additional and higher bids. On the other hand, the debtor will often want a quick marketing period to quickly inject proceeds into the estate and to satisfy its stalking-horse bidder. The stalking-horse bidder may want a quick sale so that it can purchase the assets before the consequences of bankruptcy affect such assets, among other reasons.

Both before and after an auction has been conducted and concluded in accordance with bankruptcy court-approved rules, it is not out of the realm of possibility for

[222] F.R.B.P. 2002(a)(2).

creditors to surface and file objections to particular aspects of the sale or the sale order, or for the creditors' committee, which may have participated in the auction, to try to renegotiate terms of the purchase contract. It also is not unheard of for potential acquirors to submit late bids and for courts to entertain those late-coming offers before the order approving a sale to any particular bidder has been entered and become final. Unfortunately, the seemingly endless opportunities for renegotiation can be standard operating procedure in an asset sale transaction in bankruptcy where the goal of maximizing value for the debtor's estate is paramount. The risk that a bidder who has been topped in the bankruptcy auction will resurface after the auction has closed and try to prevail with a higher (albeit late) bid is discussed below in Part III.A.4.b.

Once the bankruptcy court approves a transaction, the sale normally can close in 15 days. Bankruptcy Rule 6004(h) provides for a 14-day automatic stay from the entry of an order approving a sale, unless the court orders otherwise. Parties that objected in the bankruptcy court can appeal from the order within that 14-day period and seek a stay from either the bankruptcy court or the district court that will hear the appeal. The same rule, however, permits the court to shorten the 14-day waiting period, and it is not unusual for a court to do so where it is shown that value will be lost if the sale does not close immediately. Typically, appeals will not be filed by unsuccessful bidders, who generally are held to lack standing to appeal an approved sale,[223] other than to challenge improprieties in the bidding process.[224] To obtain a stay of the closing of the sale, an appealing party will generally be required to post a bond to protect the debtor against any damages that could result from delay. Such a bond may be prohibitively expensive. Absent a stay, the transaction will close.

(iii) Transfer Taxes

Asset sales made pursuant to a plan of reorganization are exempt from state and local transfer taxes under section 1146(a) of the Bankruptcy Code. However, this exemption is not applicable to asset sales made pursuant to section 363 rather than

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[223] *See In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 531 (3d Cir. 1999); *Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 388 (2d Cir. 1997).

[224] *In re Colony Hill Assocs.*, 111 F.3d 269, 274 (2d Cir. 1997) (holding that unsuccessful bidder had standing to assert that successful bidder destroyed the "intrinsic fairness" of the sale transaction and lacked good faith).

under a plan of reorganization.[225] These taxes can be substantial. For example, the sales tax payable on transfers of tangible personal property generally is 9.5% in Los Angeles[226] and 8.875% in New York City (combined state and city rates),[227] numbers large enough to make a difference to a buyer or seller in a bankruptcy sale (depending on which of them has bargained to be liable for the payment). These taxes generally would not be incurred in the context of a sale of stock of the owner of the relevant property;[228] however, they will be incurred in an asset sale, such as a section 363 sale in bankruptcy, unless another exception applies. In addition, asset sales by corporate issuers may result in significant federal and state corporate income tax liability (depending on the tax basis of the assets disposed of and the availability of NOLs and other tax attributes to offset any resulting gain), which generally would not arise upon a sale of stock of the ultimate parent corporation. Where such taxes are a major economic issue, resort to folding the sale into a plan of reorganization should be considered.

(iv) Successor Liability Risks

A section 363 sale order does not guarantee freedom from successor liability. When drafting an asset purchase agreement and proposed court order that will govern and approve the section 363 sale transaction, a purchaser must carefully specify what liabilities are to be assumed. Because any voluntary assumption on the part of a purchaser may itself create successor liability, overbreadth in drafting

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[225] *Fla. Dep't of Revenue* v. *Piccadilly Cafeterias, Inc.*, 554 U.S. 33 (2008). However, at least one court held that this exemption is applicable to asset sales when the sale closes after the plan is confirmed. *See In re NEW 118th, Inc.*, 398 B.R. 791 (Bankr. S.D.N.Y. 2009).

[226] Cal. Dep't Tax & Fee Admin., *California Sales and Use Tax Rates by County*, CDTFA-95 Rev. 14 (10-18) (Operative Oct. 1, 2018), https://www.cdtfa.ca.gov/formspubs/cdtfa95.pdf.

[227] N.Y.C. Dep't Fin., *New York State Sales and Use Tax* (last visted Mar. 26, 2019), www1.nyc.gov/site/finance/taxes/business-nys-sales-tax.page (Business NYS Sales Tax).

[228] Thirty-six states (including the District of Columbia, California, Florida, Illinois, Massachusetts, New Jersey New York, and Pennsylvania) impose transfer taxes on transfers of owned real property; those that do not include Indiana, Kansas, Louisiana and Oregon (except one parish or county in each), and Texas. A handful of states (including New York) impose a transfer tax on the transfer of leases. Some states and localities impose real estate transfer taxes on indirect transfers in two different ways. First, the transfer of a controlling interest in an entity that owns real property or an interest therein is taxed—notably, this applies in New York State (0.4%) and New York City (up to 2.625%); states with similar taxing regimes include Connecticut, Maine, New Jersey and Washington. Second, the transfer of an entity that is primarily engaged in the real estate business or otherwise has significant real estate ownership interests is taxed—this applies in the District of Columbia, New Hampshire, Illinois, Maryland, Rhode Island and Pennsylvania.

can result in unexpected liabilities, even where the court is otherwise willing to limit the purchaser's liability.[229] Failure to include language specifically releasing the purchaser from certain claims can similarly result in unexpected liabilities.

Courts may carefully scrutinize transactions that appear to have the sole purpose of shielding an asset purchaser from liability or other obligations that would be imposed under state law. In *Nelson* v. *Tiffany Industries, Inc.*,[230] the Ninth Circuit Court of Appeals indicated that if a purchaser induced the seller to file bankruptcy in order to avoid successor liability, such liability would nonetheless attach.[231] Likewise, in *Esopus Creek Value LP* v. *Hauf*,[232] the Delaware Chancery Court refused to allow a company to enter into an asset purchase agreement that would immediately be followed by a bankruptcy filing where the court found that this procedure was contemplated solely as a means of avoiding certain corporate and securities-law obligations. The Delaware Chancery Court acknowledged that it lacked the power to enjoin the company's bankruptcy filing, but determined that it could enjoin the company from entering into an agreement before a filing.[233] Moreover, as discussed above in Part III.A.2.a.iii.C of this outline, the scope of section 363(f)'s protection is limited to purchasing property free and clear of *interests*; by contrast, as discussed in Part III.B.4 of this outline, a sale pursuant to a chapter 11 plan enjoys the benefit of section 1141 of the Bankruptcy Code, which discharges liabilities of the debtor for *claims* and therefore could result in broader protection from unwanted liabilities.[234]

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[229] *See, e.g.*, *Am. Airlines* v. *Robinson (In re Trans World Airlines, Inc.)*, 180 F. App'x 330, 333 (3d Cir. 2006) (buyer held to have assumed workers' compensation claim); *Mickowski* v. *Visi-Trak Worldwide, LLC*, 321 F. Supp. 2d 878, 883 (N.D. Ohio 2003) (liability for patent infringement not cut off by terms of order); *Clean Harbors, Inc.* v. *Arkema, Inc. (In re Safety-Kleen Corp.)*, 380 B.R. 716, 736-37 (Bankr. D. Del. 2008) (purchaser assumed environmental liability at issue under terms of acquisition agreement and sale order).

[230] 778 F.2d 533 (9th Cir. 1985).

[231] *Id.* at 538.

[232] 913 A.2d 593 (Del. Ch. 2006).

[233] *Id.* at 604-05.

[234] *See Volvo White Truck Corp.* v. *Chambersburg Bev., Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944, 948-49 (Bankr. N.D. Ohio 1987) (finding that while tort claims were not barred against asset purchaser by virtue of purchase because they did not constitute "interests," they were barred due to discharge under debtor's chapter 11 plan). *But see In re Grumman Olson Indus., Inc.*, 445 B.R. at 249 ("'Interests in property' as used in section 363(f) include 'claims' that arise from the assets being sold."); *In re Trans World Airlines, Inc.* 322 F.3d 283, 288-89 (3d Cir. 2003)

3. The Nuts and Bolts of a 363 Sale

The typical procedure for a section 363 sale of substantial assets that commences before a seller has filed a case under chapter 11 would consist of the following:

- The board of directors of the seller decides to file for bankruptcy and sell assets or the entire company through a section 363 sale.

- The seller and its investment banker or broker, if any, market the assets, either privately or publicly, to likely purchasers, with a view to filing a bankruptcy petition with a contract from a bidder in hand.

- After a bidder is identified as offering the highest and best price, agreement on a term sheet, including bid protections for the bidder as "stalking horse," is reached.

- The seller negotiates with the bidder and the debtor's prepetition and postpetition financing sources and enters into a definitive purchase agreement with the bidder, subject to higher and better bids resulting from an auction process to occur after bankruptcy is filed. The buyer will list which contracts and leases it would like the debtor to assume and assign.[235] An asset purchase agreement with a chapter 11 debtor is usually relatively unconditional. The buyer's recourse for misrepresentations is through an escrow or a holdback of part of the purchase price. All of a seller's obligations under the purchase agreement are expressly conditioned on obtaining bankruptcy court authorization, and the seller commits to promptly file a motion with the bankruptcy court to establish procedures for obtaining approval of the sale.

- The seller simultaneously prepares other necessary papers for bankruptcy filings, including a petition in bankruptcy and schedules of assets and liabilities. Debtor-in-possession financing also must be found, fees, terms and documents must be negotiated

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("Some court have narrowly interpreted interests in property to mean *in rem* interests in property, such as liens. . . . However, the trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property.'").

[235] *See* Part III.B.8.

and motions for bankruptcy court approval must be prepared. In some circumstances, it may be appropriate for the prospective acquiror to provide the debtor-in-possession financing.

- The seller files its chapter 11 petition, accompanied by a motion seeking approval of the bidding procedures and other matters requiring immediate authorization, such as debtor-in-possession financing. Exhibits to the sale motion should include forms of court orders to be entered upon approval of sale and proposed bidding procedures.

- Parties in interest may object to the bidding procedures, and the bankruptcy court conducts a hearing, typically within ten to fifteen days of the filing of the motion.

- Once approved, the sale process then goes forward in accordance with the bidding procedures. Prospective competing bidders will have a specified time period to conduct due diligence and submit conforming bids. If other qualified bidders emerge, an auction is then conducted in the bankruptcy court, or, more typically, at the offices of the seller's law firm. A stenographer should be present to record the auction. (This is especially important if changes to the asset purchase agreement are agreed to during the auction and will need to be reduced to writing later.) After each round of bidding, the seller and its advisors, together with the creditors' committee and its advisors, as well as the debtor-in-possession financing source, will analyze the bid, and conclude which bid is highest and best.

- Once the winning bid is selected, a motion is made to the bankruptcy court requesting confirmation of the winning bid. Parties in interest may object to the sale generally, as well as to the proposed assumption and assignment of the identified contracts and leases. Once all objections are resolved or overruled, a court order approving the sale is entered.

As can readily be seen, the process is intended to cause, and often succeeds in causing, a stalking horse to be outbid between the time it enters into the initial agreement with a seller and the entry of a bankruptcy court order approving a sale. As a result, the eventual purchase price may greatly exceed the amount of

the stalking-horse bid. For example, in 2012, a stalking-horse bid of $125 million for substantially all of the assets of A123 Systems, Inc.[236] was topped by a winning bid at auction of more than two times the stalking-horse bid;[237] in 2014, a stalking-horse bid of $84 million for substantially all of the assets of Natrol Inc.[238] was topped by a winning bid at auction of $133 million;[239] and in 2018, a stalking-horse bid of $200 million for substantially all assets of Nine West Holdings, Inc.[240] was topped by a winning bid at auction of approximately $340 million.[241]

However, the mere presence of a stalking-horse bidder, particularly a strategic buyer, may cause other potential bidders to assume a sale to the stalking horse is a foregone conclusion and decline to invest the time and resources required to formulate a bid. It is thus not uncommon for the stalking horse to be the only and winning bidder.[242]

It is advisable for the winning bidder to insist that the debtor seek bankruptcy court confirmation of the auction results as soon as possible to avoid the possibility of a bidder belatedly seeking to top its bid. The pressure in a bankruptcy case to achieve as much value as possible for the estate means that

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[236] *See* Motion to Approve Bidding Procedures ¶ 12, *In re A123 Sys., Inc.*, No. 12-12859 (Bankr. D. Del. Oct. 16, 2012), ECF No. 34.

[237] *See* Order Authorizing the Sale of Certain Assets of the Debtors, Ex. 1, at § 2.5, *In re A123 Sys., Inc.*, No. 12-12859 (Bankr. D. Del. Dec. 11, 2012), ECF No. 640-1.

[238] *See* Notice of Selection of Stalking Horse Bidder, Ex. 1, at § 3.01, *In re Natrol, Inc.*, No. 14-11446 (Bankr. D. Del. Nov. 3, 2014), ECF No. 648-1.

[239] *See* Order Approving Asset Purchase Agreement ¶ 27, *In re Natrol, Inc.*, No. 14-11446 (Bankr. D. Del. Nov. 12, 2014), ECF No. 709.

[240] *See* Motion to Approve Bid Procedures ¶ 3, *In re Nine West Holdings, Inc.*, No. 18-10947 (Bankr. S.D.N.Y. Apr. 6, 2018), ECF No. 20.

[241] *See* Order Approving the Sale of Substantially All of the Assets of the Debtors' Nine West, Bandolino, and Associated Brands Free and Clear, Ex. 1, at 25, *In re Nine West Holdings, Inc.*, No. 18-10947 (Bankr. S.D.N.Y. June 20, 2018), ECF No. 404-1.

[242] *See, e.g.*, Order Approving Sale of Substantially All of the Debtors' Assets, *In re Synergy Pharm., Inc.*, No. 18-14010-JLG (Bankr. S.D.N.Y. Mar. 1, 2019), ECF No. 484 (Bausch Health Companies, Inc. was stalking horse and winning bidder); Order Approving Asset Sale, *In re Dendreon Corp.*, 14-12515-LSS (Bankr. D. Del. Feb. 20, 2015), ECF No. 410 (Valeant Pharmaceuticals International was stalking horse and winning bidder).

violations of bidding rules approved in a bankruptcy court order sometimes are countenanced, although some bankruptcy judges will respect prior-approved procedures. In the *Comdisco* chapter 11 case, for example, the winning bidder at an auction for a portion of the debtor's business was SunGard Data Systems, Inc. The U.S. Department of Justice sued to enjoin the closing on antitrust grounds and Hewlett-Packard Company, the losing bidder, came back with a new offer. Although Hewlett-Packard's bid was lower than SunGard's winning bid, the Creditors' Committee asked the court to approve it because it was not subject to antitrust risk. The court ruled that the debtor was required to continue with SunGard, in compliance with the court-approved bidding rules.[243]

In another example, in April 2009, in the bankruptcy of Polaroid Corp., the court ordered the reopening of the auction for the assets of Polaroid, allowing the two leading bidders, Patriarch Partners and a joint venture between Hilco Consumer Capital and Gordon Brothers Group LLC, to resubmit bids after the close of the auction.[244] Patriarch originally had won the auction with a $59.1 million bid, which certain creditors and the debtor preferred to Hilco-Gordon Brothers' $61.5 million bid, which included less cash but granted creditors a larger stake in the company that would be created from the acquired assets. The Creditors' Committee objected to the results and asked the court to reopen bidding. Ultimately, the Hilco-Gordon Brothers joint venture won the auction ten days after the order extending it, paying $87.6 million for Polaroid's assets. And in the bankruptcy of Cloverleaf Enterprises, the owner of Rosecroft Raceway in Maryland, the chapter 11 trustee held an auction and declared a winning bidder. Just days later, at the hearing to approve the sale, the bidding was reopened and a new auction was held in the courtroom, with the original winner ultimately prevailing with a higher bid.[245]

Recognizing that reopening bidding implicates the competing concerns of maximizing creditors' recovery and ensuring finality and regularity in bankruptcy sales, courts sometimes use a "sliding scale" approach, holding that the further

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[243] *See* Bret Rappaport & Joni Green, *Calvinball Cannot Be Played on This Court: The Sanctity of Auction Procedures in Bankruptcy*, 11 J. BANKR. L. & PRAC. 189 (2002) (analyzing the *Comdisco* case in depth).

[244] *See* Order Continuing Hearing to Authorize (I) the Sale of Certain of the Debtors' Assets, Free and Clear of Liens, Claims, Encumbrances and Interests; and (II) the Granting of Related Relief, *In re Polaroid Corp.*, Case No. 08-46617 (GFK) (Bankr. D. Minn. Apr. 7, 2009), ECF No. 266.

[245] Transcript of Hearing, *In re Cloverleaf Enters., Inc.*, No. 09-20056 (Bankr. D. Md. Feb. 2, 2011), ECF No. 740.

along the parties have gotten in the sales process, and the more "crystallized" their expectations of finality, the less likely an "upset" bid will be allowed.[246] Thus, if the bankruptcy court has already entered a sale order, a late offer generally will not be allowed except where the previously accepted bid was grossly inadequate or tainted by fraud or mistake.[247] Before a sale order is entered, however, some bankruptcy courts have exercised discretion to accept upset bids.[248] Courts may be inclined to exercise that discretion depending on the formality and complexity of the auction process, the difficulty in valuing offers and the clarity of the auction's resolution.[249] To reduce the risk of upset bids being accepted before a sale order is entered, parties should agree to and follow clear terms in the bidding procedures that unambiguously specify when bidding is to end or, in a suitable

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[246] *See In re Food Barn Stores, Inc.*, 107 F.3d 558, 565 (8th Cir. 1997) (allowing an upset bid after considering these expectations).

[247] *See id.* at 564; *Corp. Assets, Inc.* v. *Paloian*, 368 F.3d 761, 768 (7th Cir. 2004); *In re Corbett*, 2018 WL 832885 at *15 (Bankr. D. Mass. 2018) ("[T]ypically, a court will reopen bidding, and thereby upset the results of a properly conducted judicial auction, only if 'there was fraud, unfairness or mistake in the conduct of the sale . . . or . . . the price brought at the sale was so grossly inadequate as to shock the conscience of the court.'" (quoting *In re Food Barn Stores, Inc.*, 107 F.3d 558, 564 (8th Cir. 1997)).

[248] *See, e.g.*, *In re Sunland, Inc.*, 507 B.R. 753, 758-62 (Bankr. D.N.M. 2014) (denying motion to approve sale at $20,050,000 when the upset bid was $25,000,000).

[249] *Compare In re Gil-Bern Indus., Inc.*, 526 F.2d 627, 629 (1st Cir. 1975) (not allowing upset bid following straightforward auction involving all-cash offers), *and In re Bigler, LP*, 443 B.R. 101, 108-12 (Bankr. S.D. Tex. 2010) (not allowing upset bid where debtor followed clear and unambiguous bidding procedures and announced a winner, who spent several days preparing to show at the sale hearing that it was ready, willing, and able to close), *with Corp. Assets, Inc.*, 368 F.3d at 770-71 (allowing upset bid where debtor changed bidding requirements without informing all bidders before auction, bidding procedures order gave debtor wide discretion to reject any bid or impose additional restrictions before sale hearing, and debtor's attorney informed bidders that auction results were not final until approved by the court); *Food Barn Stores*, 107 F.3d at 566 (allowing upset bid where the bankruptcy judge adopted "very informal and flexible" bidding procedures, the "auction [was] marked by a lack of applicable rules and guidelines," the late bidder had received no notice that the auction was about to close and submitted a late bid "[l]iterally seconds" after the end of the auction was announced), *Consumer News & Bus. Channel P'ship* v. *Fin. News Network Inc. (In re Fin. News Network Inc.)*, 980 F.2d 165, 170 (2d Cir. 1992) (allowing upset bid where the auction process was "complex and fluid," "[n]o clear winner emerged," "creditors were split as to which offer presented the best terms, and the bankruptcy court did not rule"); *and In re Fairfiled Sentry Ltd.*, 539 B.R. 658, 668-71 (Bankr. S.D.N.Y. 2015) (citing *In re Fin. News Network Inc.* in holding that "the decision whether to reopen the auction is committed to the bankruptcy court's discretion"), *aff'd*, 690 Fed. Appx. 761 (2d. Cir. 2017), *cert. denied*, 138 S. Ct. 285 (2017).

case where a public auction is not undesirable, hold the auction on the record in open court.[250]

It is not uncommon for a debtor/seller to require that the second highest bid agree to remain bound by its bid until the winning bidder closes and therefore act as the "backup bidder." A cautious bidder, and in particular the stalking-horse bidder, should resist this to preserve for itself the opportunity to reconsider its options if the high bidder walks away from its deal.

Typically, unsuccessful bidders do not have standing to appeal an approved sale, nor do potential bidders have standing to challenge the bid procedures, unless they are also creditors.[251] A stalking-horse bidder, however, may seek to include in the bidding procedures standing to object to the debtors' determination of qualified bidders prior to the commencement of an auction. As discussed in detail in Part IV.B, the purchase of claims in a bankrupt company is one way to obtain standing to make these challenges. Investors should realize that timing is crucial for these purposes. Once it is involved in the bidding process, a bidder may be forced to enter a nondisclosure agreement with a standstill provision that would preclude the acquisition of claims to obtain standing.

4. Bidding Incentives

Bidding incentives serve at least three useful functions for a company selling its assets: (1) attracting or retaining an initial bid, (2) establishing a bid minimum, and (3) attracting additional bidders.[252] In general, courts permit debtors to use

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[250] *See Bigler*, 443 B.R. at 116-17 (not allowing upset bid where debtor followed clear bidding procedures and conducted the auction "in a manner that, in all facets, was beyond reproach," but stating also that "the most appropriate approach to maximizing value for the estate—and also the soundest method of maintaining confidence in the system—is to hold auctions in the courtroom, on the record, with the Court serving as auctioneer").

[251] *Compare In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527, 531 (3d Cir. 1999) (disappointed bidder who was not a creditor lacked appellate standing), *with Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 388 (2d Cir. 1997) (disappointed bidders had standing as creditors of the estate); *and In re Magnesium Corp. of Am.* v. *Buchwald*, 571 B.R. 534 (S.D.N.Y 2017) (while unsuccessful bidders generally lack standing to challenge a bankruptcy court's order approving a sale of estate assets, unsuccessful bidder challenging intrinsic fairness of sale of estate assets—*i.e.*, alleging bad faith by one or more participants—has standing).

[252] *See In re Integrated Res., Inc.*, 147 B.R. 650, 662 (S.D.N.Y. 1992) (analyzing a break-up fee and stating that the "appropriate question" was whether the fee "served any of three possible useful functions: (1) to attract or retain a potentially successful bid, (2) to establish a bid standard

bidding incentives as long as the parties negotiate at arm's length and such incentives encourage, rather than chill, bidding for the assets.[253]

a. *Types of Bidding Incentives and Protections*

Sellers customarily offer potential stalking horses incentives and protections to induce them to act as a stalking horse. Typical bidding protections are discussed below.

(i) Expense Reimbursement

At a minimum, a stalking horse will require that a seller commit to reimbursing the out-of-pocket costs of its due diligence, generally subject to a cap, in the event that it is outbid. One area of dispute is whether expense reimbursement is limited to out-of-pocket costs or whether compensation for time invested by a prospective purchaser's personnel is included as well. Provided that an initial bidder has made a fully committed, unconditional bid, expense reimbursement makes sound economic sense for a seller's estate, which benefits from a stalking horse's efforts to the extent of the excess of the ultimate purchaser's price over the stalking horse's offer, minus the cost of reimbursement.[254] An expense reimbursement provision thus is considered to be the least controversial form of bidding protection.[255]

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or minimum for other bidders to follow, or (3) to attract additional bidders"), *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993).

[253] *See id.* at 657 (considering relationship of parties and whether incentive "hamper[s]" bidding); *cf. O'Brien Envtl. Energy*, 181 F.3d at 535 (holding that bidding incentives such as break-up fees will be approved only if they are actual and necessary expenses of the estate); *In re Energy Future Holding Corp.*, 904 F.3d 298 (3d Cir. 2018), *petition for cert. filed*, *Nextera Energy, Inc.* v. *Elliott Assocs., L.P.*, No. 18-967 (Jan. 24, 2019).

[254] *See* Paul B. Lackey, Note, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 COLUM. L. REV. 720, 738-40 (1993) (analyzing economic implications of bidding incentives).

[255] For purchases of small amounts of assets, courts have approved fees in the amount of actual expenses up to 30% of the purchase price. *See, e.g.*, *AgriProcessors, Inc.* v. *Fokkena (In re Tama Beef Packing, Inc.)*, 321 B.R. 496, 498 (B.A.P. 8th Cir. 2005) (approving grant of expenses totaling 29.4% of ultimate purchase price of $153,000).

(ii) Break-Up Fees

A break-up fee is "an incentive payment to a prospective purchaser with which a company fails to consummate a transaction."[256] Generally, a seller agrees to provide a stalking horse with a break-up fee of a specified dollar amount or a percentage of the transaction value (often in the range of 3%) if the stalking horse's bid attracts better offers and the seller consummates a sale to a higher bidder. One area of potential contention is whether the stalking horse will be paid the fee if an alternative purchaser is selected but the deal is not ultimately consummated. Measuring the transaction value for purposes of applying the percentage break-up fee (for example, the extent to which assumed liabilities should be included in "transaction value") is another potential point of contention. The amount of a break-up fee creates an initial bidding increment, as a seller will not accept a bid lower than the sum of the stalking horse's offer plus the break-up fee (plus expense reimbursement). Break-up fees in bankruptcy are not unique to section 363 sales. They also have been used to incentivize stalking-horse bidders in agreements to purchase an entire debtor company pursuant to a chapter 11 plan of reorganization.[257]

Break-up fees are more controversial than expense reimbursement provisions because they provide an opportunity for a stalking horse to "profit" at the expense of a seller's estate. Stalking horses and sellers often characterize break-up fees as compensation for establishing a bidding floor and for the opportunity cost of the time and money invested by the stalking horse in preparing a bid.[258] This argument is likely most powerful with acquisitions that have a high degree of certainty of closing. Detractors note that a break-up fee also can be a powerful tool for a seller aiming to "steer" a sale to a favored prospective purchaser, *e.g.*, a

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[256] *Integrated Res.*, 147 B.R. at 653. Break-up fees also are known as termination fees because they represent compensation for the termination (or break-up) of the relationship between a seller and a stalking horse.

[257] *See In re Fruit of the Loom, Inc.*, 274 B.R. 631 (D. Del. 2002) (approving $22.5 million break-up fee representing 2.75% of $835 million bid to purchase debtor corporation); *In re Adelphia Commc'ns Corp.*, 336 B.R. 610, 639 (Bankr. S.D.N.Y. 2006) (discussing a $443 million break-up fee, which represented 2.5% of $17.6 billion bid to purchase debtor corporation), *aff'd*, 342 B.R. 122 (S.D.N.Y. 2006).

[258] *See* Paul B. Lackey, Note, *An Empirical Survey and Proposed Bankruptcy Code Section Concerning the Propriety of Bidding Incentives in a Bankruptcy Sale of Assets*, 93 COLUM. L. REV. 720, 739-40 (1993).

bidder that is likely to retain current management after completing the sale.[259] Further, because opportunity costs are difficult to quantify, a large break-up fee can be difficult to defend in the face of arguments that it may chill bidding, will reduce the net proceeds to the seller's estate, or is being used to improperly influence the outcome of an auction. The larger the break-up fee, the more the fee has the potential to chill bidding and prove detrimental to the interests of the debtors' estate.[260] It is generally accepted among bankruptcy practitioners that a court is likely to approve a break-up fee that does not exceed 3% of the transaction price, although break-up fees in bankruptcy cases are often smaller.[261]

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[259] *See id.* at 738 (noting that "bidding incentives that allow management to give a particular bidder an overwhelming advantage in the bidding process can be manipulated by management to protect its own interests").

[260] The debtor will normally include proposed bid protections in a stalking-horse purchase agreement attached to its motion to approve bid procedures. There are few published opinions declining to approve a proposed purchase agreement based on the size of the break-up fee alone. For a rare example, see *In re Twenver, Inc.*, 149 B.R. 954, 956-57 (Bankr. D. Colo. 1992) (holding that 11% break-up fee on $450,000 bid was unreasonable and could hamper prospects for a higher bid). Courts tend to focus on the *process* by which a debtor and a stalking-horse bidder entered into an agreement. *See Gey Assocs. Gen. P'ship* v. *310 Assocs., L.P.*, 2002 WL 31426344, at *2 (S.D.N.Y. Oct. 29, 2002) (noting that bankruptcy judge rescinded approval of break-up fee after discovery that there were already multiple interested bidders and that imposition of break-up fee would hamper the debtor's ability to sell to highest bidder), *aff'd sub nom., In re 310 Assocs.*, 346 F.3d 31 (2d Cir. 2003); *In re Bidermann Indus. U.S.A., Inc.*, 203 B.R. 547, 552-53 (Bankr. S.D.N.Y. 1997) (rejecting topping and expense-reimbursement fees on finding of "manifest self-dealing" and lack of full and fair bidding process, and characterizing fees of 4.4% to 6% as "on the high side").

[261] Courts tend to approve as reasonable break-up fees in the range of 1.5% to 4% of the purchase price in the bid, with an additional allowance for expenses incurred by the bidder; however, "the inquiry, by its very nature fact intensive, cannot be reduced to a mathematical equation." *La. Mun. Police Emps. Ret. Sys.* v. *Crawford*, 918 A.2d 1172, 1181 (Del. Ch. 2007). For cases approving relatively small break-up fees, see *In re AWI Delaware, Inc.*, No. 14-12092 (Bankr. D. Del. Oct. 3, 2014), ECF No. 271 (reducing break-up fee from 3.3% to 2.5% on bid worth approximately $152 million); *In re Fortunoff Fine Jewelry & Silverware, LLC*, 2008 WL 618986, at *47 (Bankr. S.D.N.Y. Feb. 15, 2008) (2.8% break-up fee, plus reimbursement of expenses up to additional 1.25%, on $80 million bid); *In re CXM, Inc.*, 307 B.R. 94, 103-04 (Bankr. N.D. Ill. 2004) (break-up fee of 3.2%, inclusive of expenses, on $6.254 million bid). For cases approving somewhat larger fees, see *In re Republic Engineered Prods. Holdings LLC*, No. 03-55118 (Bankr. N.D. Ohio Nov. 7, 2003), ECF No. 205 (7.5% break-up fee, plus reimbursement of expenses up to additional 2.5%, on $40 million bid); *In re Philip Servs. Corp.*, No. 03-37718 (Bankr. S.D. Tex. Aug. 4, 2003), ECF No. 524 (14.3% break-up fee, plus reimbursement of expenses up to additional 2.9%, on $35 million bid); *In re Magnachip Semiconductor Fin. Co.*, No. 09-12008 (Bankr. D. Del. Sept 1, 2009), ECF No. 250 (approving a 10% break-up fee, albeit one that was payable in stock, not cash); *cf. In re Glob. Crossing Ltd.*, 295 B.R. 726, 740 n.51 (Bankr. S.D.N.Y.

Three percent, however, is not a hard and fast limit, especially in situations of acute seller distress. In the *Lehman Brothers* chapter 11 case, a break-up fee of 8% on a bid for the investment management company Neuberger Berman was approved due to the bankruptcy court's concern that failure to approve the break-up fee could cause the purchaser to walk and leave no bidders for the asset.

(iii) Minimum Overbids

In addition to requiring any competing bidder to top a stalking horse's bid by the amount of the break-up fee, bidding procedures often require the initial competing bid to exceed a stalking-horse bid by a certain amount. Minimum overbids generally are approved if reasonable. Aside from providing some modicum of deal protection, they minimize the incurrence of unnecessary transaction costs related to overbids that do not materially benefit an estate.

(iv) The Asset Purchase Agreement and Other Terms

A sale transaction typically involves important terms other than the price. For example, provisions regarding the scope of the assets included in the sale, the treatment of executory contracts, the assumption or other treatment of debt secured by the assets included in the sale, any upfront deposit against the purchase price, the treatment of management and other employees, the timing of the closing, and closing conditions may be material in the context of a particular transaction.

The importance of the buyer's deposit is illustrated by a sale of assets by the Innkeepers USA Trust. The successful bidder at the auction signed a commitment letter that provided for a deposit of less than 2% of the value of the successful bid (a deposit of $20 million in comparison to a bid value of more than $1.1 billion) and that arguably limited the seller's damages in the event of a default by the bidder to the deposit. In light of the small size of the deposit and the limitation on damages, the seller had little ability to enforce consummation of the sale. Accordingly, when the bidder threatened to walk away from the sale, the seller was forced to renegotiate, resulting in a substantially reduced purchase price.[262]

2003) (applying business judgment rule and approving liquidated damages provision that had "the effect of a break-up fee in material respects" of 12% of $250 million bid).

[262] *See* Order (I) Authorizing Fixed/Floating Debtors to Enter Into Second Amended Commitment Letter, (II) Approving (A) Modifications to Fixed/Floating Plan and Confirmation Order and (B) Amended New HoldCo/Midland Commitment, (III) Authorizing Fixed/Floating Debtors to Settle

In the past, it was not uncommon to require that competing bidders be limited to the form of purchase contract negotiated between the debtor and the stalking horse. This may be viewed as enhancing the comparability of competing offers, creating a "level playing field" or reducing the costs of the transaction, but it also can provide effective—and arguably unfair—protections for the stalking horse that will insist on a structure that suits it and may be designed to chill bidding by firms with different bid characteristics. For example, a financial purchaser may agree to a purchase agreement that does not require the inclusion of a provision conditioning its obligations on compliance with antitrust laws and obligates the purchaser to retain the existing management, whereas a strategic purchaser might find such provisions problematic. Today, competing bidders generally are permitted to submit non-conforming bids, though they are generally required to submit a markup of their proposed form against the stalking horse's form of agreement.

b. *When to Seek Bidding Protections*

Ideally, a potential purchaser would obtain the benefit of bidding protections and incentives *before* commencing due diligence. That is unusual, however, and, given the need for court approval, could not occur prior to the bankruptcy filing. Normally, a seller is unable to provide a binding commitment before the potential purchaser incurs its due diligence costs, and a potential purchaser must proceed on a non-binding promise from a seller that, if the potential purchaser is the stalking horse, then the seller will seek to include the agreed-upon bid protections in the bid procedures order submitted for bankruptcy court approval.[263]

Although reimbursement for actual expenses incurred, subject to a cap, is unlikely to meet substantial opposition, a seller is unable to provide a stalking-horse bidder with any assurance that break-up fees or other protections and incentives will be approved. Thus, in determining the sufficiency of proposed bidding incentives

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Adversary Proceeding Upon Consummation of Modified Fixed/Floating Plan, *In re Innkeepers USA Trust*, No. 10-13800 (SCC) (Bankr. S.D.N.Y. Oct. 21, 2011), ECF No. 2181.

[263] *See, e.g.*, *In re Beth Isr. Hosp. Ass'n of Passaic*, 2007 WL 2049881, at *15-16 (Bankr. D.N.J. July 12, 2007) (declining to authorize break-up fee pursuant to an agreement that was not binding on the debtor because it was not approved by the bankruptcy court); *In re Asia Glob. Crossing, Ltd.*, 326 B.R. 240, 256 (Bankr. S.D.N.Y. 2005) (holding that a debtor that has executed a contract for the sale of its assets is not bound by that contract until it receives court approval, and that, prior to such approval, the debtor may, without consequence, abandon the contract and withdraw the application for court approval), *adhering to in relevant part on reargument*, 332 B.R. 520 (Bankr. S.D.N.Y. 2005); *see also* Part II.C (pertaining to pre-negotiated 363 sales).

and protections, a potential bidder often will have to take into consideration two factors: (1) the precedents and predictability of the specific bankruptcy court to which the bidding procedures will be submitted for authorization and (2) whether opposition may be expected from key parties in interest, including the official committee of unsecured creditors and the U.S. Trustee.

Another risk to stalking-horse bidders that is difficult to eliminate is that, prior to a bid procedures hearing, a competing bidder may make a superior bid and demand to be substituted as the stalking horse. When a stalking horse is replaced prior to or at the bid procedures hearing, it can be difficult for that party to convince the court and other stakeholders that it is entitled to the deal protection measures previously agreed to by the debtor, such as a break-up fee. In the 2005 bankruptcy of the commodities brokerage Refco, the initial stalking-horse bidder, J.C. Flowers & Co., emerged with a bid to save the company, which was rapidly losing customers in the wake of revelations of financial fraud, and sought a break-up fee in excess of $20 million. However, at the bid procedures hearing, competing bidders offered to take Flowers' terms (which significantly undervalued the company) with no break-up fee at all. The court declined to approve the Flowers break-up fee and Man Financial ultimately prevailed in the auction. Similarly, after Penn National Gaming agreed to make a stalking-horse bid for the troubled Fontainebleau Las Vegas casino resort in November 2009, Carl Icahn emerged just days before the bid procedures hearing with an offer that topped Penn's and, after a live auction between Penn and Icahn at the bid procedures hearing, was ultimately selected as the stalking horse. When no other bidders emerged and Penn did not submit another bid at the subsequent auction, Icahn won uncontested. Despite coming forward with serious bids, creating a floor for the seller and investing their own resources in due diligence and negotiations, these would-be stalking-horse bidders were left with no bid protections or even expense reimbursements to show for their trouble.[264]

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[264] An alternate route for losing bidders to seek reimbursement of legal fees and expenses is section 503(b) of the Bankruptcy Code, which authorizes parties that made a "substantial contribution" to the chapter 11 case to seek reimbursement of their expenses. In *In re S & Y Enters., LLC*, the court held that the losing bidder had standing to apply for reimbursement on this basis. 480 B.R. 452, 459-64 (Bankr. E.D.N.Y. 2012), *aff'd sub nom., Bedford JV, LLC* v. *Skylofts, LLC*, 2013 WL 4735643 (E.D.N.Y. 2013). But ultimately, the court declined to award reimbursement because the bidder failed to prove that its expenditures were "of such consequence to the bankruptcy process and the parties as a whole that the debtor's estate, rather than the entity should bear the reasonable cause of those contributions. . . ." 480 B.R. at 455, 466-67. However, other courts have awarded such reimbursement. *See, e.g.*, Order Granting Motion for Approval of Administrative Claim, *In re Rogers Bancshares, Inc.*, No. 13-13838 (Bankr. E.D. Ark. Oct. 30, 2013), ECF No. 156.

A related risk is that, to obtain court approval of its bid protections, the stalking-horse bidder will have to increase its offer in the face of a competing bid. For example, in the 2012 bankruptcy of Residential Capital LLC ("ResCap"), Fortress Investment Group LLC signed a stalking-horse agreement for ResCap's mortgage unit that included a $72 million break-up fee, but did not promptly obtain court approval of its bid protections. One month later, Berkshire Hathaway offered the same price with only a $24 million break-up fee. Fortress was ultimately able to remain the stalking horse, but only by raising its bid by $125 million and agreeing to reduce its break-up fee to $24 million.

To combat these risks, buyers with the leverage to do so may seek to insert a "no shop" provision in the stalking-horse asset purchase agreement, prohibiting the seller from cooperating with other potential bidders until after the stalking-horse bid is approved at the bid procedures hearing. Although such a provision may be unenforceable against the debtor until the court approves it, at a minimum it gives the stalking-horse bidder the right to terminate its bid if the debtor courts other offers prior to the hearing. A debtor who disregards such a provision thus risks termination of its stalking-horse bid before an alternate bid can be secured.

Even when no competing stalking-horse bid emerges, some bankruptcy courts have been reluctant to approve bidding protections and incentives at a bid procedures hearing, particularly in the face of substantial opposition, and thus have deferred a decision on such matters until a final hearing on a sale. A bidder that does not receive its bargained-for protections at a bid procedures hearing generally is entitled under the purchase agreement to withdraw its bid. If a bidder moves forward with that bid, however, it may later find it difficult to obtain desired protections and incentives in the event it is outbid.[265]

Investors considering transactions in bankruptcy proceedings in the Third Circuit, most notably Delaware, should be aware that the standard for approval of break-up fees there may be somewhat more onerous than in other jurisdictions. Rather

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[265] *See In re Reliant Energy Channelview, LP*, 403 B.R. 308, 311 (D. Del. 2009) (holding that the bankruptcy court did not abuse its discretion in denying a stalking horse's break-up fee where the bid was not conditioned on approval of the break-up fee), *aff'd*, 594 F.3d 200 (3d Cir. 2010); *In re Dorado Marine, Inc.*, 332 B.R. 637, 640 (Bankr. M.D. Fla. 2005) (holding that stalking-horse bidder was not entitled to negotiated break-up fee where initial court order had deferred consideration of fee); *In re Diamonds Plus, Inc.*, 233 B.R. 829, 831 (Bankr. E.D. Ark. 1999) (refusing to award break-up fee because of lack of binding agreement approved by court). *But see NBR Shoppes, LLC* v. *SB Capital Grp., LLC (In re Antaramian Props., LLC)*, 564 B.R. 762 (M.D. Fla. 2016) (approving break-up fee award even though stalking horse bidder had not submitted a binding purchase agreement).

than deferring to the debtor's business judgment, courts in the Third Circuit evaluate whether a break-up fee is "actually necessary to preserve the value of the estate" under the Bankruptcy Code's postpetition administrative expense provision, section 503(b).

This standard for approval stems from the decision of the Third Circuit Court of Appeals in *In re O'Brien Environmental Energy*,[266] which declined to approve a break-up fee where the potential purchaser did not obtain bid protection prior to bidding and seemingly would have bid regardless of whether a break-up fee was offered.[267] Without articulating a specific set of factors for determining the propriety of a break-up fee, the court concluded that any right to a break-up fee would have to derive from Bankruptcy Code section 503's requirement that an administrative expense be "actually necessary to preserve the value of the estate."[268] The court found that awarding the fee was unnecessary to the preservation of the estate because the large difference between the stalking horse's original offer and the final price "strongly suggest[ed] that it was the prospect of purchasing [the debtor] cheaply, rather than the prospect of break-up fees or expenses, that lured [the stalking horse] back into the bidding."[269] The court also found the break-up fee to be unnecessary because the stalking horse presented no evidence that its bid was a catalyst for further bidding, rather than simply a minimum bid. Finally, because the debtor gathered and provided to all bidders much of the information they needed to decide whether to bid, and the stalking horse had "strong financial incentives to undertake the cost of submitting a bid," the court found that reimbursement of expenses was unnecessary to preserve value for the estate.[270]

A later opinion from the Third Circuit, in *In re Reliant Energy Channelview LP*,[271] involved an asset purchase agreement with Kelson Channelview LLC, which contained certain bid protections, including a break-up fee, and required the debtors to seek court approval of those protections. The bankruptcy court

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[266] 181 F.3d 527 (3d Cir. 1999).

[267] *Id.* at 532-38.

[268] *Id.* at 532-33, 535-37.

[269] *Id.* at 537.

[270] *Id.* at 537-38.

[271] 594 F.3d 200 (3d Cir. 2010).

approved some of the bid protections but rejected the break-up fee and declined to authorize the sale without a competitive auction. Kelson did not participate in the auction and was outbid. Following *O'Brien*, the Third Circuit concluded that the break-up fee was not necessary to preserve the estate because Kelson's agreement was conditioned only on the debtors seeking approval of the bidding protections, not on the court's actual approval. The fact that Kelson made its bid without assurance that it would be paid a break-up fee "destroy[ed] Kelson's argument that the fee was needed to induce it to bid."[272] The court also recognized that the break-up fee provision might have benefited the estate by preventing Kelson from abandoning the transaction, but agreed with the bankruptcy court that such a benefit was outweighed by the potential harm the break-up fee could do by chilling bidding, especially given evidence of another suitor willing to make a higher offer.[273]

Notably, as a practical matter, bankruptcy courts in Delaware have generally found that proposed break-up fees satisfy the standard set forth in *O'Brien* and *Reliant Energy*, and break-up fees are regularly approved in that district.

However, one case from the Third Circuit offers a cautionary tale regarding break-up fees: In the bankruptcy of Energy Future Holdings, the bankruptcy court approved a $275 million break-up fee for the proposed purchaser NextEra. One year later, the debtors terminated the transaction because regulatory approval was not forthcoming. A creditor filed a motion to reconsider the bankruptcy court's order approving the break-up fee.[274] The bankruptcy court granted the motion, finding that an "incomplete and confusing" record was made at the hearing, resulting in the court's not having understood that the break-up fee would be payable if the deal failed due to lack of regulatory approval.[275] The bankruptcy court's decision was affirmed by the Third Circuit.[276] The Energy Future Holdings case highlights the importance of describing the conditions for payment of a break-up fee in clear terms prior to court approval.

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[272] *Id*. at 207.

[273] *Id*. at 207-08.

[274] *In re Energy Future Holdings Corp.*, 575 B.R. 616 (Bankr. D. Del. 2017), *aff'd*, 904 F.3d 298 (3d Cir. 2018), *petition for cert. filed*, *Nextera Energy, Inc.* v. *Elliott Assocs., L.P.*, No. 18-967 (Jan. 24, 2019).

[275] *Id.* at 631-33.

[276] 904 F.3d at 298.

5. To Be or Not to Be the Stalking Horse

In addition to the bidding incentives and protections often granted to a stalking horse, discussed in Part III.A.4.a of this outline, there are other advantages for a prospective purchaser to be selected as the stalking-horse bidder, as well as a few potential drawbacks.

A stalking horse generally has superior access to information from and communication with a debtor. The stalking horse will be able to perform its due diligence before others are on the scene and will have some ability to set the transaction timetable. Members of a seller's management likely will make themselves available to a stalking horse, making it possible for the stalking horse to perceive value in the company or the assets that cannot be perceived from the outside, as well as to uncover potential risks that may otherwise be difficult to discern. This superior information flow allows the stalking horse to make its bid with greater confidence and potentially outbid competitors. Competing bidders, which will likely bid with less time to perform due diligence and less access to management, may discount their price to compensate for the greater uncertainty as to the value and risk of the assets they are bidding on. A stalking horse also has the advantage of being able to shape the transaction from the outset—identifying the baseline of assets to be purchased and otherwise driving the auction process along with the debtor.

Why might a potential bidder choose not to be the stalking horse? In bankruptcy, a prospective acquiror will always be given the opportunity to bid even without investing the time and expense that a stalking horse must put in. A competing bidder has the ability to wait and see what the stalking horse will do and take advantage of the stalking horse's due diligence, its work in drafting a purchase contract, and its signaling of value by making an initial bid. Further, the stalking-horse bidder, even after reaching agreement with the company and postpetition financing sources, faces the risk that a creditors' committee or others will object to the stalking-horse agreement and seek to retrade important terms, including deal milestones and bid protections. Absent consensual resolution of such objections, or while negotiation is occurring, the stalking horse may be drawn into expedited litigation (including discovery) without assurance that the stalking-horse agreement will be approved and the debtor will cover the related cost.

6. Credit Bidding

a. *Credit Bidding Existing Claims*

Whether in a foreclosure sale governed by state law or in a bankruptcy sale pursuant to section 363, secured creditors ordinarily may use their claims as consideration for a purchase of their collateral—a practice known as "credit bidding."[277] Since the creditor is not bidding with cash, it may be able to bid more than a competing cash bidder. Additionally, as the holder of the debt secured by the property, a credit bidder benefits directly from any increase in the sale price if its credit bid results in higher competing cash bids. And if no one shows up to become a stalking-horse bidder to kick off an auction, or only one bidder surfaces, a bid from a debtor's secured creditors can stimulate bidding and drive prices higher.

Section 363(k) of the Bankruptcy Code gives the court discretion to limit the right to credit bid "for cause." Historically, this discretion has been applied very narrowly, and creditors were generally permitted to credit bid the entire face amount of their claims, even if acquired at a discount.[278] However, difficulties can arise if the secured creditors' claims or liens to be used in a credit bid are subject to challenge, either by the debtor or by other creditors.[279] For example, in the 2012 bankruptcy of United Retail Group, Inc., a potential purchaser acquired and attempted to credit bid secured claims originally held by the debtor's parent. The creditors' committee objected to the proposed credit bidding on several grounds, including the calculation of the amount of the secured claims and the

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[277] *See, e.g.*, 11 U.S.C. § 363(k) (providing that a holder of a claim that is secured by property may bid at a sale of such property and offset such claim against the purchase price unless the court for cause orders otherwise).

[278] *See Cohen* v. *KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448, 459 (3d Cir. 2006) ("[Section 363(k)] empowers creditors to bid the total *face* value of their claims—it does not limit bids to claims' economic value."); *In re Monarch Beach Venture, Ltd.*, 166 B.R. 428, 433 (C.D. Cal. 1993) (noting that six prior decisions that had reviewed a secured creditor's right to credit bid under 363(k) had each allowed the creditor to bid its entire claim).

[279] *See, e.g.*, *In re L.L. Murphrey Co.*, 2013 WL 2451368, at *5 (Bankr. E.D.N.C. June 6, 2013) (determining that "cause" existed to deny right to credit bid because creditor's lien was disputed); *Nat'l Bank of Commerce* v. *McMullan (In re McMullan)*, 196 B.R. 818, 835 (Bankr. W.D. Ark. 1996) (holding that "at any such sale, [the secured creditor] shall not be entitled to offset bid any of its claimed liens or security interests under 11 U.S.C. § 363(k) . . . because the validity of its liens and security interests are unresolved"), *aff'd*, 162 F.3d 1164 (8th Cir. 1998), *cert. denied*, 525 U.S. 1019 (1998).

insider status of the entity that had originally held the secured claims. Although a settlement permitting the purchaser to credit bid the claims in question was reached in a timely fashion, a buyer seeking to employ a credit bid must be mindful that such a bid may be subject to the risk and delay of litigation. In the recent Sears bankruptcy, the only bid for the assets other than from liquidators was a credit bid from an insider, ESL Investments, which was the holder of 49% of Sears' equity and much of its secured debt.[280] The court approved the credit bid, but only after an extensive investigation conducted by the debtors and the creditors' committee, and a multi-day hearing.[281]

Rulings in *In re Fisker Automotive Holdings, Inc.* and *In re The Free Lance-Star Publishing Co.* reflect a possible expansion of the bankruptcy courts' exercise of discretion to limit the use of credit bidding "for cause" under section 363(k). In *Fisker*, the bankruptcy court expressed concern that the debtor and the holder of a secured loan acquired at a steep discount were seeking to "short-circuit the bankruptcy process" through use of a credit bid, which the court believed would freeze out other bidders. The court capped the credit bid at the price the holder had paid for the loan, and ordered a competitive auction; Fisker was ultimately sold to another bidder.[282] In *Free Lance-Star Publishing*, the bankruptcy court similarly limited the right of a potential acquiror to credit bid using a claim that it had acquired at a discount as part of a loan-to-own strategy.[283] In both cases, the disappointed credit bidder was refused leave to take an immediate appeal.

A subsequent decision of the Bankruptcy Court for the Southern District of New York in the chapter 11 cases of retailer Aéropostale, however, may serve to clarify the meaning of the "for cause" limitation on credit bidding. In *Aéropostale*, the debtors sought to disqualify a secured lender from credit bidding in a proposed 363 sale. Rejecting the debtors' argument (which relied largely on

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[280] *See* Sears Holdings Corporation, Quarterly Report (Form 10-Q) (Dec. 13, 2018) at 56.

[281] *See* Part III.A.1.c.

[282] *In re Fisker Auto. Holdings, Inc.*, 510 B.R. 55, 60-61 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 546036 (D. Del. Feb. 7, 2014), *additional appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

[283] *In re The Free Lance-Star Publ'g Co.*, 512 B.R. 798, 814 (Bankr. E.D. Va. 2014) (amount of credit bid capped on grounds that (1) holder lacked valid lien on all property being sold, (2) holder had engaged in inequitable conduct that "damped [sic] interest in the auction," and (3) limiting amount of credit bid would "restore enthusiasm for the sale and foster a robust bidding process"), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

Fisker and *Free Lance-Star*) that a credit bid could be rejected if it chilled the bidding process, the bankruptcy court allowed the secured lender to credit bid the full amount of its secured claim in the sale. Critically, the court found the potential chilling effect of a credit bid, in and of itself, does *not* constitute sufficient grounds to preclude or limit a credit bid, noting that in *Fisker* and *Free Lance-Star*, the courts were concerned with other problematic conduct by the lenders whose bids were rejected.[284]

Difficulties may also arise if not all creditors within a class holding a lien on a debtor's assets are willing to credit bid. In *In re GWLS Holdings, Inc.*,[285] the Bankruptcy Court for the District of Delaware suggested that it would not allow dissenting lenders to prevent a class of lenders from credit bidding. Relying on contractual provisions that entitled the collateral agent under a secured credit facility to exercise all available rights and remedies on behalf of lenders—including the right to dispose of collateral—the court concluded that the collateral agent could credit bid the whole of the outstanding debt under the credit facility over the objection of a lender holding a small portion of the debt.[286]

A similar result was reached by the Bankruptcy Court for the Southern District of New York in *In re Metaldyne Corp.*[287] Relying on *GWLS* and the Second Circuit's decision in *Chrysler*—which held that an agent could consent to the sale

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[284] *In re Aéropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016). *See also In re Family Christian, LLC*, 533 B.R. 600 (Bankr. W.D. Mich. 2015) (refusing to approve a credit-bid sale to a party that, as a "consultation party" to the auction, had been privy to certain information that allowed it to gain an unfair advantage over other bidders); *In re Charles St. African Methodist Episcopal Church of Bos.*, 510 B.R. 453 (Bankr. D. Mass. 2014) (denying in part a motion to limit a credit bid where the debtor's counterclaims did not relate to the validity of the secured creditor's claims or liens, but requiring the secured creditor to include in its bid cash in an amount equal to a break-up fee payable to the stalking-horse bidder); *In re RML Dev., Inc.*, 528 B.R. 150, 155 (Bankr. W.D. Tenn. 2014) ("'[C]redit bidding' under § 363(k) does *not* allow the holder of an allowed secured claim to exercise an absolute right to purchase its collateral and offset that purchase by its allowed secured claim.").

[285] 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009).

[286] *Id.* at *5-6; *see also* Transcript of Hearing at 33-34, *In re Foamex Int'l, Inc.*, No. 09-10560 (Bankr. D. Del. May 26, 2009) ("[I]t's a natural consequence of the authority given the agent in the credit agreement that it be able to do a 363(k) credit bid. . . . To read it any other way would . . . lead to chaos in 363 sales."); *In re GSC, Inc.*, 453 B.R. 132, 183-84 (Bankr. S.D.N.Y. 2011) (agent's authority to credit bid over a lender's objection upheld where dissenting lenders gave the agent such authority in the prepetition credit agreement).

[287] 409 B.R. 671 (Bankr. S.D.N.Y. 2009), *aff'd*, 421 B.R. 620 (S.D.N.Y. 2009).

free and clear of a group of lenders' liens—the court in *Metaldyne* authorized the sale of substantially all of the debtor's assets in accordance with the credit bid of an agent for a consortium of lenders under a term loan facility. The court rejected the argument of a holder of less than 1% of the facility that each lender had the sole authority to control the bidding of its own claim where the loan documents gave the agent the right to "exercise any and all rights afforded to a secured party" under applicable law.[288] It remains to be seen whether courts will follow *GWLS* and *Metaldyne* in cases where the dissenting lenders form a larger portion of the relevant class of secured creditors.

Special problems in obtaining clear title from a credit bid can arise if the collateral is subject to junior liens. Foreclosing credit bidders often take the view that their credit bid is equivalent to putting up cash, receiving it back and then paying down their debt (*i.e.*, "round-tripping" their cash). Accordingly, they argue that any competing bid that defeats their bid must be in cash or at least include enough cash to pay off their debt. Competing bidders, particularly those junior to a credit bidder, may have difficulty putting up enough cash, depending upon the economic environment, and are likely to bid cash together with other securities.

A typical multi-lien intercreditor agreement will provide that junior creditors may not receive any proceeds until the senior creditors are paid in full in cash. Thus, junior bidders hoping to bid in a combination of cash and securities or other assets may not be able to distribute anything but cash to the senior creditors. This issue was squarely presented in the section 363 sale of WestPoint Stevens, when Carl Icahn and others in his "cross-lien" group (which held debt in multiple classes) attempted to bid with both cash and a minority share of equity in the acquiring entity's parent company. The district court found that nothing in the underlying credit documents or the Bankruptcy Code allowed the Icahn bid's in-kind (rather than cash) distribution to the first-lien lenders, and vacated the bankruptcy court's approval of the sale to Icahn.[289] However, on appeal, the Second Circuit concluded that, although the district court had correctly interpreted the underlying credit documents, section 363(m) precluded the district court from overturning the sale and allowed only the limited remedy of increasing the compensation to various interested parties.[290]

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[288] *Id.* at 676-78.

[289] *In re WestPoint Stevens, Inc.*, 333 B.R. 30, 47-55 (S.D.N.Y. 2005).

[290] *Contrarian Funds, LLC* v. *Aretex LLC (In re WestPoint Stevens, Inc.)*, 600 F.3d 231, 254-60 (2d Cir. 2010). Section 363(m) is discussed in Part III.A.2.a.iii.A of this outline.

Another typical intercreditor provision forbids junior creditors from taking any action that would hinder or delay the senior creditors' enforcement of their liens on the collateral. Such a provision also could potentially prohibit a competing junior bid, depending on the court's willingness to enforce it.

Since the Third Circuit's decision in *Cohen* v. *KB Mezzanine Fund II, L.P.*—better known as "the SubMicron case"—there is little doubt that creditors may credit bid up to the full face amount of their debt regardless of the underlying collateral value.[291] This allows a credit bidder whose claim is substantially undersecured to push the price well above the value of the asset. Nevertheless, creditors should bear in mind that credit bidding less than face value may have other benefits, such as conserving a cushion to defeat competing bids, or preserving an unsecured deficiency claim that can be voted on the debtor's proposed plan of reorganization.

In the context of chapter 11 plan confirmation, the Supreme Court held in *RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank*[292] that proponents of a plan that calls for collateral to be sold free and clear of liens cannot circumvent the requirement of section 1129(b)(2)(A)(ii) that secured creditors be allowed to credit bid their collateral by instead giving those secured creditors the "indubitable equivalent" of their claims under section 1129(b)(2)(A)(iii). After *RadLAX*, the right to credit bid can no longer be limited more readily through the plan process than it is under section 363. Under both provisions of the Bankruptcy Code, credit bidding must be allowed when an asset is sold free and clear of liens, "unless the court for cause orders otherwise."[293]

b. *Secured DIP Financing Debt as Currency*

A potential acquiror may want to consider the value of extending post-bankruptcy secured DIP financing to the debtor as a mechanism to facilitate the purchase of assets in bankruptcy. Where it is apparent that a debtor (1) requires DIP financing to fund its operations in bankruptcy and (2) will be selling desirable assets during the case, the acquiror can provide secured financing on the express understanding

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[291] 432 F.3d 448, 459-61 (3d Cir. 2006). *But see* Part III.A.6.a (discussing the *Fisker* case and *Free Lance-Star* and how the ability to credit bid may be limited "for cause").

[292] 566 U.S. 639 (2012).

[293] *See* 11 U.S.C. § 1129(b)(2)(A)(ii) (providing for sale free and clear of liens under plan "subject to section 363(k)"); 11 U.S.C. § 363(k) (requiring credit bidding to be allowed "unless the court for cause orders otherwise").

that it will be entitled to "bid in" or "credit bid" that debt to purchase those assets of the debtor that secure its financing, as section 363(k) of the Bankruptcy Code expressly permits. Or, more ambitiously, the DIP financing can be used as currency to fund a plan in which the DIP lender takes control and cashes out the prepetition creditors for their appropriate share of the loan proceeds.[294]

It is also possible to have the DIP financing exchanged for equity in the post-bankruptcy entity. For example, in the General Growth Properties bankruptcy, Pershing Square Capital Management proposed a credit agreement for DIP financing pursuant to which, upon the effective date of a plan of reorganization, General Growth would issue warrants to Pershing to acquire equity securities of General Growth and certain subsidiaries for a nominal exercise price. While an alternative DIP agreement ultimately prevailed, that agreement, like the Pershing proposal, allowed General Growth to satisfy a portion of the DIP obligation with stock of the reorganized company. A recent example of a DIP-to-equity conversion is the bankruptcy of Erikson Inc., in which the plan contained a feature allowing the DIP lenders to convert their debt into a significant portion of the equity in the reorganized company.[295]

The provision of DIP financing may also enable a secured creditor to receive enhanced treatment of its prepetition claims when more straightforward DIP financing is difficult to obtain in the marketplace. For example, so-called "roll-up" financing structures afford prepetition secured lenders the opportunity to convert their prepetition claims into postpetition claims. Bankruptcy courts have approved such structures when the prepetition lenders were oversecured and agreed in connection with the roll-up to advance new money loans that the debtor demonstrated were critical in a situation where the debtor had no reasonable alternative financing options. Typically, roll-up loans are secured by postpetition liens on substantially all of the debtor's assets, subject only to the liens securing the new money loans, and enjoy superpriority administrative expense status, again subject only to such status afforded to the new money loans.[296]

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[294] *See, e.g.*, Robin Phelan & Ocean Tama, *The Use of DIP Financing as a Mechanism to Control the US Corporate Restructuring Process*, Int'l Bar Assoc. Legal Prac. Div., Oct. 2010, http://commission.abi.org/sites/default/files/DIP_Financing_Phelan-Tama.pdf.

[295] *See* Notice of Filing of Plan Supplements, Ex. 12, at 265, *In re Erikson Inc.*, No. 16-34393, (Bankr. N.D. Tex. Mar. 8, 2017), ECF No. 493.

[296] *In re Lyondell Chemical Company* illustrates this structure. In *Lyondell*, the bankruptcy court approved an arrangement whereby a portion of the debtor's first lien prepetition debt was rolled up into a new tranche of postpetition DIP loans in connection with the first lien lenders' provision of

7. Antitrust Review

Section 7 of the Clayton Act prohibits the acquisition of "stock or other share capital . . . where . . . the effect of such acquisition may be substantially to lessen competition or to tend to create a monopoly."[297] The Clayton Act also provides for a pre-notification and waiting period requirement for acquisitions over certain thresholds.[298] These amendments to the Clayton Act are collectively referred to as the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act").[299] Acquisitions of voting securities and/or assets in a bankruptcy proceeding, whether as part of a 363(b) sale or in a chapter 11 plan of reorganization, are not immune from the HSR process or antitrust scrutiny.[300] However, the HSR Act provides for an expedited review process and certain filing exemptions in recognition of the unique nature of bankruptcy proceedings. In addition, parties may be able to avail themselves of arguments that are more likely to succeed in the bankruptcy context to further expedite the agencies' investigation of a transaction that raises substantive concerns.

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new-money financing to the debtors. The court order approved characterization of the roll-up loans as postpetition secured obligations entitled to superpriority administrative expense status, junior only to new money tranches of the DIP facility. While requiring the debtors to use reasonable efforts to repay the roll-up loans upon consummation of a plan, the final DIP order permitted the debtors to refinance the roll-up loans with debt securities of the reorganized debtor subject to pre-negotiated terms regarding maturity and security. Ultimately, the approved roll-up loans proved to be key fulcrum currency and enabled confirmation of the Lyondell chapter 11 plan. Final Order Authorizing Debtors to Obtain Post-Petition Financing, *In re Lyondell Chem. Co*., No. 09-10023 (REG) (Bankr. S.D.N.Y. Mar. 1, 2009), ECF No. 1002; *see also* Final Order Authorizing Debtors to Use Cash Collateral and Obtain Postpetition Financing, *In re Aleris Int'l, Inc.*, No. 09-10478 (BLS) (Bankr. D. Del. Mar. 18, 2009), ECF No. 299 (approving DIP loan consisting of $575 million revolver and approximately $500 million new money term loan and permitting DIP lenders to roll up as much as $540 million of prepetition debt).

[297] *See* 15 U.S.C. § 18.

[298] For additional details, Christina C. Ma & Monica L. Smith, *FTC Revises Merger Filing and Interlocking Directorate Thresholds*, WACHTELL, LIPTON, ROSEN & KATZ (Mar. 4, 2019), http://www.wlrk.com/webdocs/wlrknew/WLRKMemos/WLRK/WLRK.26377.19.pdf.

[299] *See* 15 U.S.C. § 18a.

[300] *See, e.g.*, F.T.C., *Analysis of Agreement Containing Consent Order to Aid Public Comment, In re Corpus Christi Polymers LLC, Alfa, S.A.B. de C.V., Indorama Ventures Plc Aloke Lohia and Suchitra Lohia, and Far E. New Century Corp.*, No. 181-0030, https://www.ftc.gov/system/files/documents/cases/181_0030_pet_analysis_12-21-18.pdf (imposing conditions—including limits on information sharing and percentage ownership—on a consortium of bidders that won a bankruptcy auction for interests in a joint venture).

a. HSR Process

As noted above, acquisitions over certain thresholds are subject to the pre-notification and waiting period requirements of the HSR Act.[301] In recognition of the time sensitivities involved in bankruptcy proceedings, the HSR Act provides for a shortened waiting period (15 days, instead of the standard 30 days) in acquisitions covered by 11 U.S.C. § 363(b).[302]

In addition, pursuant to 16 C.F.R. § 802.63(a) ("HSR Rule 802.63(a)"), an acquisition of assets or voting securities in connection with a "*bona fide* debt work-out" is *exempt* from the HSR Act requirements so long as the creditor extended credit "in a *bona fide* credit transaction entered into in the ordinary course of the creditor's business." The Federal Trade Commission (the "FTC") staff has determined that distributions of voting common stock to creditors under a plan of reorganization fall within the definition of a "bona fide debt work-out."[303] The exemption also includes secondary purchasers of a debtor's debt securities, as well as banks and other traditional lenders.[304]

There is, however, an exception to this exemption: the "vulture fund" exception. Under this exception, if the fact that a debtor intends to file bankruptcy becomes public and, subsequently, an investor acquires claims against the debtor and seeks to obtain securities or assets in satisfaction thereof, HSR Rule 802.63(a) will not exempt that acquisition of securities or assets.[305] However, where a creditor holds

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[301] As discussed in Part IV.D.5, acquisitions of debt, as opposed to voting securities or assets, are exempt from the HSR requirements, but may still be subject to investigation pursuant to the Clayton Act.

[302] 16 C.F.R. § 803.10(b).

[303] *See* AM. BAR ASS'N, SECTION OF ANTITRUST LAW, PREMERGER NOTIFICATION PRACTICE MANUAL 287 (5th ed. 2015).

[304] *See, e.g.*, FTC Informal Interpretation, File No. 0407006 (Aug. 11, 2004) (applying exemption to bond fund that acquired the debtor's bonds in the secondary market pre-bankruptcy), www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/0407006; FTC Informal Interpretation, File No. 9502019 (Feb. 22, 1995), www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/9502019.

[305] FTC Informal Interpretations, File No. 0202007 (Feb. 21, 2002), www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/0202007; FTC Informal Interpretations, File No. 0204006 (Apr. 22, 2002), www.ftc.gov/enforcement/premerger-notification-program/informal-interpretations/0407006; *see also* AM. BAR ASS'N, SECTION OF ANTITRUST LAW, PREMERGER NOTIFICATION PRACTICE MANUAL 287 (5th ed. 2015).

a mix of bonds acquired *before* and *after* the public announcement of the intention to initiate bankruptcy proceedings, the exchange of bonds in the first group remains eligible for the HSR Act exemption.

For transactions that raise real, substantive antitrust concerns warranting an investigation beyond the initial 15-day waiting period, the antitrust agencies have historically expedited or prioritized their review where one of the parties is in financial distress or subject to a bankruptcy proceeding, even in situations where the relevant agency believed that a divestiture was required to resolve competition concerns. To that end, the antitrust authorities have permitted transactions involving distressed companies to close prior to the culmination of the investigation;[306] in at least one instance, the FTC obtained a "blank check" that would permit it to order any divestiture it later determined was needed.[307] Similarly, in the June 2011 Nortel bankruptcy auction, the DOJ conducted initial reviews and cleared a number of participating bidders (including Google and Apple) to provide a level playing field. After the bankruptcy court approved the sale to the Rockstar Bidco consortium (Microsoft, Apple, EMC, Sony, Ericsson, and Research In Motion), however, the DOJ conducted its own investigation and ultimately required that the consortium take certain remedial actions and make certain behavioral commitments.[308]

Courts deciding whether to grant a preliminary injunction in an agency challenge to an acquisition may also be sensitive to the exigencies of bankruptcy

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[306] *See*, *e.g.*, Press Release, FTC, Fidelity National Financial Settles FTC Charges that Its Acquisition of LandAmerica Subsidiaries Reduced Competition in Title Information Markets (July 16, 2010), http://www.ftc.gov/opa/2010/07/fidelity.shtm. An eventual settlement of the complaint brought by the FTC required Fidelity to sell a portion of its ownership in a title information database, as well as share title data with competitors in five other locations.

[307] Press Release, FTC, FTC Order Requires Tops Markets to Sell Seven Penn Traffic Supermarkets (Aug. 4, 2010), http://www.ftc.gov/opa/2010/08/tops.shtm. Penn Traffic had declared bankruptcy in November 2009. The only two bidders for Penn Traffic's assets were Tops Markets and a liquidator. To avoid the liquidation, the FTC and Tops Markets entered into an agreement that permitted Tops to purchase the assets but required Tops to divest any stores which the FTC later determined presented competitive concerns. The eventual FTC settlement required the divestiture of seven stores.

[308] *See* Press Release, U.S. Dep't of Justice, Statement of the Department of Justice's Antitrust Division on Its Decision to Close Its Investigations of Google Inc.'s Acquisition of Motorola Mobility Holdings Inc. and the Acquisitions of Certain Patents by Apple Inc., Microsoft Corp., and Research In Motion Ltd. (Feb. 13, 2012), https://www.justice.gov/opa/pr/statement-department-justice-s-antitrust-division-its-decision-close-its-investigations.

proceedings.[309] For instance, on August 13, 2013, the DOJ and six states and the District of Columbia filed suit in federal district court to block the merger of US Airways Group, Inc. ("US Airways") and AMR Corporation ("American").[310] American was in bankruptcy at the time and the merger with US Airways was to be effected pursuant to a plan of reorganization. The bankruptcy judge confirmed the plan on September 12, 2013, noting that if the DOJ succeeded in blocking the merger, American would have to develop a new plan to exit court protection. The district court took into account American's financial condition when denying the government's request to schedule the trial for March 2014 and established an expedited schedule under which trial would begin on November 25, 2013. Absent the merger, American would arguably have remained in bankruptcy until late 2014 as it fashioned a new reorganization plan, revised financial projections, and renegotiated its terms with bondholders, unions and other creditors. On October 1, 2013, the district court denied the DOJ's attempt to postpone all proceedings because of the federal government shutdown, indicating that it was essential that the DOJ attorneys continue to litigate the case promptly due to the merger's time sensitivities and the high financial stakes. On November 12, 2013, the DOJ announced a settlement of the lawsuit by all parties.[311]

b. Substantive Review

Other than the exemption under HSR Rule 802.63(b) and the shortened 15-day waiting period under the HSR Act, discussed above, parties should not otherwise expect the antitrust agencies' review of a distressed transaction to be any different analytically than of a non-distressed transaction.

One defense uniquely available to parties to a distressed transaction is the so-called "failing firm" or "flailing firm" defense. The antitrust agencies and courts

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[309] *See, e.g.*, *FTC* v. *Lab. Corp. of Am.*, 2011 WL 3100372, at *23 (C.D. Cal. Mar. 11, 2011). The FTC withdrew its appeal of the district court's denial of the injunction. Press Release, FTC Withdraws Appeal Seeking a Preliminary Injunction to Stop LabCorp's Integration With Westcliff Medical Laboratories (Mar. 24, 2011), http://www.ftc.gov/opa/2011/03/labcorp.shtm.

[310] Complaint, *United States* v. *US Airways Grp.*, No. 1:13-CV-01236-CKK (D.D.C. Aug. 13, 2013).

[311] Press Release, U.S. Dep't of Justice, Justice Department Requires US Airways and American Airlines to Divest Facilities at Seven Key Airports to Enhance System-wide Competition and Settle Merger Challenge (Nov. 12, 2013), https://www.justice.gov/opa/pr/justice-department-requires-us-airways-and-american-airlines-divest-facilities-seven-key.

have long acknowledged the failing firm defense—that a transaction will not reduce competition because the acquired entity is otherwise "failing."[312] The defense is historically very difficult to prevail on as the parties must demonstrate that (1) the acquired company is unable to meet its obligations as they come due; (2) the acquired company has no realistic prospect for successful reorganization; and (3) there are no other viable acquirors that pose less anticompetitive risk.[313] Recently, in *Energy Solutions*, a district court rejected the failing firm defense, finding that the parties had failed to make a good faith effort to elicit reasonable alternative offers that would pose a lesser risk to competition.[314] In at least one instance, a bankruptcy court conducted a hearing to vet would-be acquirors and determined that there were no viable alternatives to the prospective buyer.[315]

The flailing/failing firm defense can also *harm* the parties' prospects of obtaining antitrust clearance, particularly if the company's declining financial position is indicative of more general industry decline or contraction. Traditionally, arguments that entry into a particular market is easy or likely or that existing players are likely to expand into new geographic markets can mitigate the antitrust agencies' competitive concerns. These arguments, however, are less persuasive to the agencies when the industry as a whole is flailing/failing.

8. The Foreign Bidder/CFIUS

Non-U.S. purchasers, or "foreign purchasers," face additional regulatory and political hurdles when bidding on U.S. assets. Any transaction in which a foreign purchaser invests in a U.S. business or a U.S. infrastructure, technology, or energy asset, or real estate located in proximity to sensitive government facilities, or that results in a foreign person obtaining access to material nonpublic technical information that affects national security may be (and, in some cases, is) subject

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[312] *See Citizen Publ'g Co.* v. *United States*, 394 U.S. 131, 136-39 (1969); U.S. Dep't of Justice & FTC, Horizontal Merger Guidelines § 11 (2010).

[313] *See, e.g.*, Bill McConnell, *Failing Upward*, THE DEAL MAGAZINE (Apr. 25, 2011) (discussing the DOJ's review process for Hercules Offshore Inc.'s purchase of oil rigs from competitor Seahawk Drilling Inc.); Debbie Feinstein & Alexis Gilman, Bureau of Competition, Federal Trade Commission, *Power Shopping for an Alternative Buyer* (March 31, 2015), https://www.ftc.gov/news-events/blogs/competition-matters/2015/03/power-shopping-alternative-buyer?utm_source=govdelivery.

[314] *See United States* v. *Energy Solutions, Inc.*, 265 F. Supp. 3d 415, 444-45 (D. Del. 2017).

[315] Ramsey Shehadeh, Joseph Larson & Ilene Knable Gotts, *The Effect of Financial Distress on Business Investment: Implications for Merger Review*s, 23 ANTITRUST 12, 15-16 (2009).

to review by the Committee on Foreign Investment in the United States ("CFIUS"), an inter-agency committee headed by the Secretary of the Treasury. There is no requirement that a transaction be approved prior to closing. However, CFIUS has the ability to investigate any transaction at its discretion.

In 2018, the Foreign Investment Risk Review Modernization Act ("FIRRMA") was signed into law.[316] Prior to FIRRMA, the statutory framework centered around voluntary filing by foreign businesses that could obtain control over a U.S. business. Initial reviews—and more in-depth reviews—depended upon the nature of the U.S. business and its potential to impact "national security." FIRRMA changed that framework in certain important respects. First, it broadened CFIUS's jurisdiction to include other investments, not just investments that could result in control. Second, instead of relying on voluntary filings, it established requirements for mandatory declarations in certain circumstances. Under the terms of FIRRMA, the mandatory filing provisions will go into effect the earlier of 18 months after its enactment or 30 days after CFIUS publishes regulations to administer these new provisions.[317]

In October 2018, CFIUS published regulations specifying certain mandatory filings for investments pursuant to a pilot program. In particular, such regulations require parties to file a notice with CFIUS for controlling and non-controlling investments in U.S. businesses that involve certain delineated critical technologies.[318] The scope of transactions with a mandatory filing requirement is expected to expand in the coming months. Notably, FIRRMA contemplates

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[316] Foreign Investment Risk Review Modernization Act of 2018, Pub. L. No. 115-232, §§ 1701-28, 131 Stat 1636, 2174-2207 (2018).

[317] *See id.* § 1727(b).

[318] CFIUS has implemented a Pilot Program to implement a portion of its expanded jurisdiction. Currently, the Pilot Program covers any "transaction by or with any foreign person that could result in foreign control" of "any U.S. business that produces, designs, tests, manufactures, fabricates, or develops a critical technology" that is "[u]tilized in connection with the U.S. business's activity in" or "[d]esigned by the U.S. business specifically for use in" any of 27 specified industries, as well as investments by a foreign person in a U.S. business that affords the foreign person access to material nonpublic technical information in the possession of the U.S. business, membership or observer rights on the board of directors or the right to nominate an individual to a position on the board of directors, or any involvement in substantive decisionmaking of the U.S. business regarding critical technology. Determination and Temporary Provisions Pertaining to a Pilot Program to Review Certain Transactions Involving Foreign Persons and Critical Technologies, 83 Fed. Reg. 51,322-344 (Oct. 11, 2018) (to be codified at 31 C.F.R. pt. 801).

mandatory filings for certain investments by foreign persons and investments by which a foreign government obtains a "substantial interest" in U.S. businesses involved in critical infrastructure, critical technology, or that would provide the foreign investor with access to sensitive personal data of U.S. citizens that may be exploited in a manner that impacts national security.[319]

For mandatory declarations, CFIUS has 30 days to respond, potentially requiring a full CFIUS notification with a full CFIUS review. FIRRMA also increased the time for consideration and approval of notifications. CFIUS has a 45-day review process to identify any national security concerns arising from a transaction, during which it can request additional information from the parties and initiate a subsequent 45-day investigation, which can be extended by 15 days upon "extraordinary circumstances." Under certain circumstances, CFIUS may also refer a transaction to the President for approval, in which case the President must announce a decision within 15 days. This potentially lengthy review process, and the possibility of disapproval by CFIUS, presents a significant obstacle for the non-U.S. bidder.

Assuming the mandatory provisions do not apply, in order to have its bid seriously considered, or at least not be subject to a heavy discount, a foreign bidder may decide to take its chances that it will not be compelled to divest the purchased assets later and agree to close without approval. In the *ClearEdge Power* case, the debtor was a manufacturer of fuel cells, which involved technology that had potential military applications. Despite the potential for a CFIUS investigation, Doosan, a Korean company, agreed to close immediately after approval of its bid. A non-U.S. bidder might also consider proposing a reverse break-up fee, which would compensate the estate for losses it might incur in the event the bid were approved by the bankruptcy court but the buyer could not close under FIRRMA.

Where possible, it is prudent for the non-U.S. bidder to make a voluntary filing with CFIUS if the likelihood of investigation is reasonably high. To reduce the risk of CFIUS rejection, non-U.S. bidders can benefit from suggesting methods of mitigation early in the review process and initiating discussions with the Treasury Department prior to a formal filing. Retaining advisors with significant CFIUS experience and crafting a communications plan is crucial to successfully navigating the CFIUS process.

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[319] CFIUS has not yet promulgated regulations pertaining to these mandatory filings.

CFIUS has played a role in at least two bankruptcy cases, which illustrate the importance of planning and accounting for the CFIUS review process. In the Hawker Beechcraft bankruptcy, the proposed sale of assets to a Chinese buyer, Superior Aviation Beijing Co., was not completed, and Hawker eventually emerged from chapter 11 as a standalone company. Although the CFIUS process had not yet begun, press reports suggest that CFIUS-related risk, and in particular the potential difficulty in separating Hawker's defense business from the remainder of the business, was a factor in the unsuccessful sale negotiations.[320] In contrast, the Chinese automotive parts manufacturer Wanxiang successfully purchased the assets of A123 Systems, an electric car battery manufacturer, in a section 363 auction and obtained CFIUS approval for the transaction. In the auction, Wanxiang paired up with the U.S.-based company Navitas, which bid separately on A123's defense business. Additionally, the deal was structured so that Wanxiang, rather than A123 and its creditors, would bear the risk of CFIUS disapproval: The parties agreed that the sale would close into a trust pending CFIUS approval, so that if CFIUS approved the sale the trust would dissolve and the assets would go to Wanxiang, but if CFIUS rejected the sale the trust would sell the assets and Wanxiang would receive the proceeds. Ultimately, the trust structure was not employed before CFIUS approved the sale. The A123 case serves as a potential model for how a non-U.S. bidder can make itself more attractive to a debtor and its constituents by minimizing the risk that a sale will not close due to failure to obtain regulatory approvals.

B. Acquisitions Through the Conventional Plan Process

The acquisition of a company through a plan of reorganization provides certain added protections and business opportunities that are not available in an acquisition under section 363. It also comes with some added challenges, as it requires the treatment of all creditors to be resolved before a plan can be confirmed, and is likely to be significantly more time-consuming than the relatively streamlined and now well-worn section 363 process.

The complexity of the chapter 11 process makes the retention of experienced counsel essential. Those who are making the business decisions involved in structuring and pursuing such a transaction, however, will also benefit from a basic understanding of the elaborate system of rules, timetables and requirements imposed by the Bankruptcy Code and the Bankruptcy Rules.

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[320] *See* Mike Spector, *Hawker Sales Talks Collapse Over Review Worries*, WALL ST. J. (Oct. 18, 2012), http://www.wsj.com/articles/SB10000872396390443684104578064402725144988.

1. Control over the Restructuring Process

a. *Venue*

A bankruptcy proceeding's location, or venue, can greatly impact the success of a potential transaction. Many debtors prefer filing in jurisdictions that have had significant experience with large and complex chapter 11 cases, most notably New York and Delaware. If any member of a corporate family is incorporated in New York or Delaware and files a bankruptcy case, any member can file there under the "affiliate rule." This ability to choose a venue based on the location of one affiliate has been repeatedly questioned in Congress, but none of the legislative proposals intended to require cases to be filed in locations more central to their operations or employees[321] have been enacted.

Some debtors attempt to establish venue in New York or Delaware by forming a subsidiary there shortly before filing bankruptcy and later "bootstrapping" their cases to those of their newly formed subsidiaries. While such practices technically satisfy the requirements of the venue statute,[322] in *Patriot Coal* the Bankruptcy Court for the Southern District of New York transferred venue out of New York "in the interest of justice," notwithstanding the existence of a newly formed New York subsidiary.[323]

The *Caesars* case also commenced with a venue dispute. Certain second lien bondholders filed an involuntary bankruptcy petition against their debtor, Caesars Entertainment Operating Co. ("CEOC"), in Delaware, and the company followed by filing voluntary chapter 11 cases in Chicago, a venue it preferred because of certain favorable law in that circuit, for the remaining companies, and then asked the Delaware bankruptcy judge to transfer venue of the CEOC case. The court granted the motion to transfer, stating that "rewarding [the petitioning second lien bondholders'] preemptive filing in another forum would set a bad precedent for

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[321] *See, e.g.*, Harold King, *Proposed Bill: Bankruptcy Venue Reform Act of 2018*, HARV. L. SCH. BANKR. ROUNDTABLE (Jan. 30, 2018), https://blogs.harvard.edu/bankruptcyroundtable/2018/01/30/proposed-bill-bankruptcy-venue-reform-act-of-2018/.

[322] A person or entity generally must reside in the district in which it files for at least 180 days prior to filing. 28 U.S.C. § 1408(1).

[323] *In re Patriot Coal Corp.*, 482 B.R. 718, 738-41 (Bankr. S.D.N.Y. 2012).

future bankruptcy cases and limit the ability of future debtors to openly negotiate with creditors prior to filing a voluntary bankruptcy petition."[324]

b. *Exclusivity*

For the first 120 days following the filing of a chapter 11 petition, the debtor has the exclusive right to propose a plan of reorganization. Additionally, if the debtor files a plan within that period, other parties in interest may not file a plan until 180 days have passed since the filing of the debtor's chapter 11 petition without creditor acceptance of a plan filed by the debtor.[325] A court may reduce or increase both the 120-day and the 180-day periods "for cause,"[326] but the Bankruptcy Code limits extensions of the exclusive periods for filing and confirming a plan to a total of 18 months and 20 months, respectively, following the petition date.[327] After the expiration of these periods, any party in interest may propose a plan.

Establishing cause to extend plan exclusivity turns on a number of factors, including, but not necessarily limited to, the following: (1) the size and complexity of the case, (2) the necessity of further time to negotiate and prepare adequate information, (3) the existence of good-faith progress toward reorganization, (4) whether the debtor is paying its debts as they come due, (5) whether the debtor has demonstrated reasonable prospects of filing a viable plan, (6) whether the debtor has made progress in negotiating with creditors, (7) the length of time the case has been pending, (8) whether the debtor is seeking the extension to pressure creditors and (9) whether unresolved contingencies exist.[328]

The 18-month limit on exclusivity, enacted in 2005, has leveled the playing field between debtors and creditors from the prior scheme (in which there was no

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[324] *In re Caesars Entm't Operating Co.*, No. 15-10047, slip op. at 20 (Bankr. D. Del. Feb. 2, 2015), ECF No. 227.

[325] 11 U.S.C. § 1121(a)-(c).

[326] 11 U.S.C. § 1121(d).

[327] 11 U.S.C. § 1121(d)(2).

[328] *See In re GMG Capital Partners III, L.P.*, 503 B.R. 596, 600-01 (Bankr. S.D.N.Y. 2014); *In re Borders Grp., Inc.*, 460 B.R. 818, 822 (Bankr. S.D.N.Y. 2011); *In re Adelphia Commc'ns Corp.*, 352 B.R. 578, 587 (Bankr. S.D.N.Y. 2006); *see also* Novica Petrovski, *The Bankruptcy Code, Section 1121: Exclusivity Reloaded*, 11 AM. BANKR. INST. L. REV. 451, 505-13 (2003).

restriction on the ability of the bankruptcy courts to extend exclusivity), as it establishes with certainty that, after a year-and-a-half in bankruptcy, a debtor's creditors will be free to file their own plan. This dynamic fosters a sense of relative urgency for all constituencies from the beginning of the case. Additionally, the limit on exclusivity can create a negotiation dynamic that helps to frame issues, as in the Lehman Brothers bankruptcy, where bondholders and derivatives dealers filed competing plans supporting and opposing substantive consolidation. In the LightSquared bankruptcy, four competing plans of reorganization were filed and voted upon after the debtors' exclusivity window expired. The shortened exclusivity period, combined with the trend toward use of section 363 sales in lieu of plans and the increased proportion of secured debt seen in chapter 11 cases, has reduced the importance of the debtor's exclusivity.

Nonetheless, with the debtor in sole control of the plan process for 18 months, exclusivity remains a critical mechanism used by debtors-in-possession to control the pace and direction of their chapter 11 cases, and a key battleground for other parties in interest. Exclusive control over the plan process gives a debtor substantial negotiating leverage in the initial stages of its bankruptcy case. Creditors, however, are not prevented from exploring an alternative plan during the exclusivity period. Although the Bankruptcy Code prohibits "solicitation" of votes absent a court-approved disclosure statement,[329] there is authority that permits the negotiation of a prospective plan during the debtor's exclusive period and before approval of a disclosure statement.[330] In *Century Glove*, the Court of Appeals for the Third Circuit held that "a party does not solicit acceptances when it presents a draft plan for the consideration of another creditor, but does not request that creditor's vote."[331] Similarly, creditors and other constituencies may be able to persuade the debtor to pursue their preferred strategic alternative, notwithstanding the continuation of the debtor's exclusivity period. In the bankruptcy of American Airlines, during the debtor's exclusivity period, creditors were able to persuade the company's board, which was committed to emerging as

[329] 11 U.S.C. § 1125(b).

[330] *Century Glove, Inc.* v. *First Am. Bank of N.Y.*, 860 F.2d 94, 101-02 (3d Cir. 1988).

[331] *Id.* at 102. *But see In re Clamp-All Corp.*, 233 B.R. 198, 204-06 (Bankr. D. Mass. 1999) (espousing minority view that distribution of an alternative plan during the exclusive period constitutes prohibited "solicitation" and is therefore prohibited).

a standalone entity, to consider a merger with US Airways, after gaining the support of key constituencies, including American's unions.[332]

From the standpoint of a potential acquiror, the debtor's 18-month exclusivity period generally necessitates working in conjunction with the debtor to formulate an acquisition strategy. While the debtor is likely to be the first choice for a partner given its exclusive control over plan proposal for the first 18 months, where the debtor is resistant to a sale, the second choice would be the official committee of unsecured creditors, which has the ability to influence the plan process and potentially obtain judicial relief terminating the debtor's exclusivity. By working with creditor constituencies to develop a superior alternative chapter 11 plan proposal, distressed investors have sometimes been able to persuade the bankruptcy court to terminate the debtor's exclusivity.[333]

c. *Mediation*

Mediation has become an increasingly important tool in large chapter 11 cases. Traditionally, mediation was regarded as a way to resolve discrete disputes between a debtor's estate and adverse parties. In recent years, however, mediation has become a multiparty undertaking which can involve claimants from all levels of a debtor's capital structure, in which resolution of the entire case through a consensual plan of reorganization is pursued.

There have been several recent examples of this trend, including in the high-profile 2015 bankruptcy of Energy Future Holdings ("EFH," formerly known as

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[332] David Koenig, *Bankrupt American Airlines Will Finally Merge with US Airways – Creating World's Biggest Airline*, BUS. INSIDER (Feb. 13, 2013), http://www.businessinsider.com/american-airlines-merging-with-us-airways-2013-2.

[333] In *In re Pliant Corporation*, the largest holder of second lien debt teamed up with the creditors' committee to develop an alternative plan that provided a superior recovery for these creditors, including the right of second lien creditors to acquire the reorganized debtor's equity through a rights offering. After a two-day trial, the bankruptcy court terminated exclusivity so that creditors might have a choice of plans, relying expressly upon the endorsement of the alternative plan by the official creditors' committee. *See* Order Terminating the Debtors' Exclusive Periods, *In re Pliant Corp.*, No. 09-10443 (MFW) (Bankr. D. Del. July 2, 2009), ECF No. 746; *see also* Transcript of Hearing, *In re Pliant Corp.*, No. 09-10443 (MFW) (Bankr. D. Del. June 30, 2009), ECF No. 765; Transcript of Hearing, *In re Pliant Corp.*, No. 09-10443 (MFW) (Bankr. D. Del. June 29, 2009), ECF No. 764. Soon thereafter, all parties settled on a chapter 11 plan substantially similar to the alternative plan, whereby a portfolio company of the second lien creditor acquired the debtor. *See In re TCI 2 Holdings, LLC*, 428 B.R. 117 (Bankr. D.N.J. 2010) (confirming alternative plan proposed by *ad hoc* committee following termination of exclusivity).

"TXU")—a $42 billion chapter 11 case stemming from one of the largest leveraged buyouts in history. In that case, Bankruptcy Judge Sontchi of the District of Delaware ordered all parties to engage in mediation after roughly a year of failed, contentious negotiations. The process ultimately resolved the most significant intercreditor disputes in the case and created a path to confirmation of a plan of reorganization.[334] Given the success achieved in the EFH bankruptcy and in other cases, mediation is likely to increasingly become a staple in large, complex chapter 11 cases. In 2016, for example, a mediator was appointed in an attempt to resolve the $18 billion bankruptcy of Caesars Entertainment Operating Co., the main operating unit of Caesars Entertainment Corp, and a largely consensual plan was ultimately confirmed.[335]

For all parties involved, mediation poses potential benefits and risks. Mediation can expedite the plan process, which can save the estate and creditors from enormous litigation fees. Mediation also carries the possibility of crafting unique solutions not normally available in litigation. However, mediation can also have downsides. All parties lose control of the negotiation process to some extent. This is particularly true for the debtor, which would otherwise be leading the pace and substance of negotiations.

2. Confirmation Requirements

An investor seeking to gain control of a company through a chapter 11 plan needs to be aware of the rights and obligations of the debtor and creditors with respect to the plan confirmation process. The Bankruptcy Code contains numerous specific requirements for confirmation of a chapter 11 plan of reorganization. A central requirement is found in section 1126(c), which provides that the acceptance of a plan requires the votes of at least two-thirds in amount and the majority in number of claims in each accepting class.[336] Additional statutory requirements for the plan confirmation process are discussed below.

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[334] *See* Order (A) Scheduling Certain Hearing Dates and Deadlines, (B) Establishing Certain Protocols in Connection with the Approval of Debtors' Disclosure Statement, and (C) Establishing the Terms Governing Mediation, *In re Energy Future Holdings Corp.*, No. 14-10979 (CSS) (Bankr. D. Del. 2015), ECF No. 4497.

[335] *In re Caesars Entm't Operating Co., Inc.*, No. 15-01145 (Bankr. N.D. Ill. 2015).

[336] 11 U.S.C. § 1126(c).

a. *Classification of Claims and Interests*

Every plan of reorganization must classify creditor claims and equity interests; that is, it must create groups of claims and interests for purposes of voting and treatment under the plan. To be placed in the same class, claims and interests must be "substantially similar,"[337] as determined by the legal nature of the claim, rather than by attributes of the claimant.[338] Debt claims cannot be placed in the same class with equity interests (such as stock or partnership interests) and different classes of equity interests generally are classified separately.[339] In addition, certain claims are accorded special priority by section 507(a) of the Bankruptcy Code—including employee wage claims up to $13,650, contributions to an employee benefit plan, consumer deposits up to $3,025, and tax claims—must be classified separately from general unsecured claims.[340]

Generally, each secured claim will be classified separately based upon its distinct collateral or lien priority.[341] Secured claims of identical rank that share in the same collateral, such as the claims of members of a secured bank group, or claims of holders of a junior secured bond issue, typically will be placed in the same class.[342]

While there is no explicit requirement that all claims or interests that are "substantially similar" be placed in the same class,[343] a plan proponent may not

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[337] 11 U.S.C. § 1122(a).

[338] *See In re Coram Healthcare Corp.*, 315 B.R. 321, 349-50 (Bankr. D. Del. 2004). *But see In re Loop 76, LLC*, 442 B.R. 713, 715-16 (Bankr. D. Ariz. 2010) (holding that claim must be separately classified if it has a non-debtor payment source), *aff'd*, *In re Loop 76, LLC*, 465 B.R. 525 (B.A.P. 9th Cir. 2012), *aff'd*, 578 F. App'x 644 (9th Cir. 2014).

[339] *See* 7 COLLIER ON BANKRUPTCY ¶ 1122.03[2], [3] (16th ed. 2010).

[340] 11 U.S.C. §§ 507(a), 1123(a)(1); *see also* 7 COLLIER ON BANKRUPTCY ¶ 1122.03[3][b] (16th ed. 2010). Section 104(a) provides a mechanism by which the monetary thresholds are automatically increased every three years. The thresholds noted above are effective as of April 1, 2019. *Revision of Certain Dollar Amounts in the Bankruptcy Code Prescribed Under Section 104(a) of the Code*, 84 Fed. Reg. 3488-01, 2019 WL 529017 (F.R.) (proposed Feb. 5, 2019).

[341] *See* 7 COLLIER ON BANKRUPTCY ¶ 1122.03[3][c] (16th ed. 2010).

[342] *See, e.g.*, *In re Keck, Mahin & Cate*, 241 B.R. 583, 589-90 (Bankr. N.D. Ill. 1999).

[343] *See, e.g.*, *In re Bos. Post Rd. Ltd. P'ship*, 21 F.3d 477, 481 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995).

separate similar claims into different classes merely to ensure that there is at least one impaired class of creditors that accepts a plan (as required for plan confirmation by section 1129(a)(10)).[344] The Bankruptcy Code, however, does permit separate classification of unsecured claims falling below a court-approved threshold amount for purposes of administrative convenience.[345] Employing this "convenience class" provision, plan proponents often choose to pay off in full all claims that fall below a threshold amount in order to avoid the expense of soliciting votes from a large number of small claimholders.

Courts also sometimes allow separate classification of similar claims for other reasons. In the long-running battle for control of the spectrum assets of LightSquared, the debtor and the Ad Hoc Committee of Secured Creditors sought to place claims held by a special purpose entity affiliated with Charles Ergen, chairman and CEO of DISH, a competitor, in a separate class from other lenders in the same prepetition term loan facility. The bankruptcy court held that the SPE's claim could be separately classified because, as an affiliate of DISH, the SPE was a competitor of LightSquared and therefore had "non-creditor" interests.[346]

b. *Impairment and Reinstatement*

As a general matter, only claims that have been "impaired" (as defined in section 1124 of the Bankruptcy Code)[347] may vote on the confirmation of the plan.[348]

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[344] *See, e.g.*, *id.* at 482-83; *In re Greystone III Joint Venture*, 995 F.2d 1274, 1279 (5th Cir. 1991) ("[T]hou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan. . . . [C]lassification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims.").

[345] 11 U.S.C. § 1122(b).

[346] *See In re LightSquared, Inc.*, 513 B.R. 56, 88-89 (Bankr. S.D.N.Y. 2014); *see also In re Coastal Broad. Sys., Inc.*, 570 F. App'x 188, 193 (3d Cir. 2014) (permitting separate classification of creditors subject to subordination agreement).

[347] Some courts have interpreted the statutory definition to permit "artificial impairment"—*i.e.*, "the technique of minimally impairing a class of creditors solely to satisfy the prerequisite to cramdown of an accepting class"—as long as the separate "good faith" confirmation requirement is not violated. *See In re Village Green I, GP*, 811 F.3d 816 (6th Cir. 2016) (holding artificial impairment does not preclude a plan from satisfying the impaired class acceptance requirement); *accord In re Village at Camp Bowie I, L.P.*, 454 B.R. 702, 707-08 (Bankr. N.D. Tex. 2011), *aff'd*, 710 F.3d 239 (2013); *see also In re Quigley Co.*, 437 B.R. 102, 126 n.31 (Bankr. S.D.N.Y. 2010) (surveying different approaches courts have taken with respect to artificial impairment).

The acceptance of a plan generally requires the affirmative votes of two-thirds in amount and the majority in number of the claims in each class.[349] Unimpaired classes are conclusively presumed to have accepted the plan.[350] A claim is considered unimpaired where the plan "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest."[351] Conversely, classes receiving or retaining nothing under a plan are deemed to reject the plan.[352] Because unimpaired classes are generally excluded from voting on the plan, the determination that a class of claims is impaired or unimpaired can have important consequences for the success or failure of a plan.

Section 1129(a)(10) of the Bankruptcy Code requires that in order to confirm a plan that leaves a class of claims impaired, "at least one class of claims that is impaired under the plan" must accept the plan, excluding the vote of any creditor who is an "insider." Where a joint plan is filed in a jointly administered bankruptcy case involving multiple related debtors, courts have differed over whether section 1129(a)(10) requires acceptance by one impaired class for each separate debtor—an interpretation empowering impaired creditors at each debtor—or whether it requires only acceptance by one impaired class pertaining to any of the debtors to whom the plan applies. At present, the majority of courts, including the only Court of Appeals decision to date, follow the "per plan" approach.[353]

An important corollary to the concept of impairment is reinstatement. Under section 1124(2), a plan can provide for a class of claims to be reinstated, which places the creditors in the same position they would have been in had the bankruptcy not occurred, subject to the benefits and burdens of the original

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[348] 11 U.S.C. § 1129(a)(8); *see also* 11 U.S.C. § 1126(f) (unimpaired classes are presumed to have accepted the plan).

[349] 11 U.S.C. § 1126(c) (the thresholds are determined based on the number of voters (*i.e.*, abstentions are not counted)).

[350] 11 U.S.C. § 1126(f).

[351] 11 U.S.C. § 1124(1).

[352] 11 U.S.C. § 1126(g).

[353] *See, e.g.*, *In re Transwest Resort Props., Inc.*, 881 F.3d 724, 729-30 (9th Cir. 2018); *JPMorgan Chase Bank, N.A.* v. *Charter Commc'ns Operating, LLC (In re Charter Commc'ns)*, 419 B.R. 221 (Bankr. S.D.N.Y. 2009). *But see In re Tribune Co.*, 464 B.R. 126, 180-83 (Bankr. D. Del. 2011) (adopting "per debtor" approach).

contract with the debtors. A claim that is properly reinstated will be de-accelerated and treated as unimpaired for purposes of voting on the bankruptcy plan.[354] In order to reinstate a claim, a debtor must cure all defaults other than "*ipso facto*" defaults through the bankruptcy plan.[355] Where a debtor's cost of borrowing under extant agreements is less than could be obtained currently in the open market, the ability to reinstate existing debt instruments can be quite valuable. As a practical matter, however, reinstating debt is only worthwhile if the debt to be reinstated has sufficient time left to maturity. The ability to reinstate also will depend on whether the original debt terms include covenants with which the reorganized debtor is unable to comply. Where a bankruptcy plan contemplates a reorganization that is inconsistent with the terms of existing debt, reinstatement of that debt is not possible.

For an investor in distressed securities, the debtor's ability to reinstate poses both opportunities and risks. On the one hand, reinstatement is a useful tool that can minimize the leverage of reinstated classes and maximize the debtor's value. On the other hand, an investor may acquire claims in contemplation of obtaining equity for them, only to have the debtor or another stakeholder pursue a plan that

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[354] 11 U.S.C. § 1124(2).

[355] *Id.* (specifying that the plan must cure any "default that occurred before or after the commencement of the case . . . other than a default of a kind specified in section 365(b)(2) of [the Bankruptcy Code] or of a kind that section 365(b)(2) [of the Bankruptcy Code] expressly does not require to be cured"). Section 365(b)(2) provides that the following list of defaults, which are so-called *ipso facto* defaults, do not require curing: "(A) the insolvency or financial condition of the debtor at any time before the closing of the case; (B) the commencement of a case under [the Bankruptcy Code]; (C) the appointment of or taking possession by a trustee in a case under [the Bankruptcy Code] or a custodian before such commencement; or (D) the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease." Bankruptcy Code section 1123(d) further provides that if a chapter 11 plan proposes to "cure" a default under a contract, the cure amount must be "determined in accordance with the underlying agreement and applicable non-bankruptcy law." Virtually all courts now hold that such a cure amount must include any default-rate interest required under either the contract or applicable non-bankruptcy law. *See, e.g.*, *In re New Invs., Inc.*, 840 F.3d 1137 (9th Cir. 2016) (rejecting prior Ninth Circuit case law that allowed a curing debtor to avoid a contractual post-default interest rate in a loan agreement in light of section 1123(d); *In re Sagamore Partners, Ltd.*, 620 F. App'x 864, 869 (11th Cir. 2015) (finding "the clear mandate of § 1123 . . . allows a creditor to demand default-rate interest as a condition for reinstating [a defaulted] loan" to the extent that the loan agreement provided for the payment of interest at the default rate); *accord In re Moody Nat'l SHS Hous. H, LLC*, 426 B.R. 667, 672 (Bankr. S.D. Tex. 2010) ("To the extent that there was ambiguity as to how to cure a default . . . that ambiguity evaporated in 1994 when § 1123(d) was added" to the Bankruptcy Code.); *In re Gen. Growth Props., Inc.*, 451 B.R. 323 (Bankr. S.D.N.Y. 2011) (same).

reinstates those claims on their original terms, depriving the investor of the ability to vote against the plan.

Reinstatement has been particularly significant in periods in which interest rates are rising and refinancing may not be possible. For example, in the 2009 bankruptcy of Charter Communications, the debtors' plan, pre-negotiated with a committee of noteholders, contemplated reinstatement of more than $11 billion in senior secured debt at favorable interest rates, which would have saved the debtors hundreds of millions of dollars in annual interest expenses compared to the then-prevailing market rates.[356] The senior secured lenders fought approval of the plan, acknowledging that their goal was to obtain an increased interest rate that reflected what would be charged for a new loan in the then-prevailing market conditions of the financial crisis.[357] The bankruptcy court rejected the senior secured lenders' argument that they were impaired by various non-monetary defaults under the senior credit agreement, and approved the plan.[358] The senior debt was thus reinstated on terms and pricing that would have been unobtainable in the market at the time the debtors filed for bankruptcy.

c. *Voting Rules*

Generally, a holder of a claim or interest that has been properly filed and to which no objection has been made is entitled to vote such claim or interest for or against a plan of reorganization.[359] A holder of a claim to which an objection has been made may file a motion requesting that the claim be temporarily allowed by the court for the purposes of voting.[360] A partially secured creditor may vote the secured and unsecured portions of its claim as if it were the holder of two separate claims.[361] Finally, as discussed in greater detail in Part IV.D.4 of this outline, claims may be disqualified from voting upon a showing of "bad faith."

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[356] *See JPMorgan Chase Bank, N.A.* v. *Charter Commc'ns Operating, LLC (In re Charter Commc'ns)*, 419 B.R. 221, 254 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 449 B.R. 14 (S.D.N.Y. 2011), *aff'd*, 691 F.3d 476 (2d Cir. 2012), *cert. denied*, 569 U.S. 968 (2013).

[357] *Id*. at 233-34.

[358] *Id*. at 252, 271.

[359] 11 U.S.C. § 1126(a); *see also In re Quigley Co.*, 383 B.R. 19, 24 (Bankr. S.D.N.Y. 2008).

[360] Fed. R. Bankr. P. 3018(a).

[361] Fed. R. Bankr. P. 3018(d); *see also* 7 COLLIER ON BANKRUPTCY ¶ 1126.02[3] (16th ed. 2010).

d. *The "Best Interests" Test—Protection for Holdouts*

While a creditor that opposes a plan may be bound by the acceptance of the plan by its class, a dissenting creditor is afforded certain limited protection by the so-called "best interests" test. The best interests test requires that each individual creditor that does not accept the plan receive at least as much as that creditor would have received in a hypothetical liquidation of the debtor under chapter 7 of the Bankruptcy Code.[362] Any individual creditor that votes to reject a plan may object to confirmation on the basis that the best interests test is not satisfied, regardless of whether its class has voted to accept the plan. As a result of this provision, the disclosure statement describing a proposed chapter 11 plan typically contains a liquidation analysis.[363]

It is rare (although not unheard of) for the best interests test to preclude plan confirmation, *i.e.*, for the bankruptcy court to find that liquidation would yield a greater recovery for the individual creditor than the plan does. It is possible, however, for the best interests test to be violated as to a holder of secured claims who asserts that it is worse off under the proposed plan than it would be if the collateral were liquidated.[364]

e. *Feasibility*

Plan confirmation requires the bankruptcy court to determine that the plan is "feasible," *i.e.*, that the debtor is not likely to need to refile bankruptcy or to liquidate after implementation of the plan (unless the plan itself provides for the debtor's liquidation).[365] Courts generally require that a plan offer a "reasonable assurance of success," but need not guarantee it.[366] In practice, this is usually not

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[362] 11 U.S.C. § 1129(a)(7)(A)(ii).

[363] 7 COLLIER ON BANKRUPTCY ¶ 1129.02[7][b][iii] (16th ed. 2010).

[364] *See In re Valencia Flour Mill, Ltd.*, 348 B.R. 573, 576-77 (Bankr. D.N.M. 2006) (secured creditor successfully objected to plan confirmation based on plan's failure to meet the "best interests" test).

[365] 11 U.S.C. § 1129(a)(11).

[366] *In re Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988); *see also In re Indianapolis Downs, LLC*, 486 B.R. 286, 298 (Bankr. D. Del. 2013) ("The purpose of the feasibility test is to protect against visionary or speculative plans. Just as speculative prospects of success cannot sustain feasibility, speculative prospects of failure will not defeat feasibility."); *In re Quigley Co.*, 437 B.R. 102, 142 (Bankr. S.D.N.Y. 2010) ("To establish feasibility, the debtor must present proof through reasonable projections, which are not speculative, conjectural or unrealistic, that there will

a difficult legal standard for a debtor to meet.[367] Feasibility may be an issue in reinstatement cases because of the risk that the financial covenants—which have not been amended—could be breached.

In evaluating whether a plan is feasible, bankruptcy courts typically consider the following factors: "(1) the adequacy of the capital structure; (2) the earning power of the business; (3) economic conditions; (4) the ability of management; (5) the probability of the continuation of the same management; and (6) any other related matters which will determine the prospects of a sufficiently successful operation to enable performance of the provisions of the plan."[368] Frequently at issue in determining feasibility is whether a debtor's business plan is overly optimistic.[369]

f. *Cramdown: A Crucial Chapter 11 Power*

Plan confirmation can be consensual—*i.e.*, by approval of all classes entitled to vote on the plan—or not. Nonconsensual plan confirmation is referred to as "cramdown"[370] because plan confirmation is crammed "down the throat of an

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be sufficient cash flow to fund the plan and maintain operations." (internal quotation marks omitted)).

[367] *See In re DBSD N. Am., Inc.*, 634 F.3d 79, 108 (2d Cir. 2011) (noting that a "small or even moderate chance of failure" does not render a plan infeasible); *see also id.* at 107-08 (specificity of evidence required to establish feasibility decreases as time period under consideration moves farther from the confirmation date (*i.e.*, evidence of feasibility immediately following implementation of the plan should be quite specific, while only generalized evidence of feasibility is necessary with respect to a period several years in the future)).

[368] *In re Young Broad. Inc.*, 430 B.R. 99, 129 (Bankr. S.D.N.Y. 2010); *see also In re Leslie Fay Cos.*, 207 B.R. 764, 789 (Bankr. S.D.N.Y. 1997) (listing three additional factors: (1) the availability of prospective capital and trade credit; (2) the adequacy of funds for equipment replacement; and (3) the provisions for adequate working capital); 7 COLLIER ON BANKRUPTCY ¶ 1129.02[11] (16th ed. 2010) (collecting authorities).

[369] *See, e.g.*, *In re Young Broad.*, 430 B.R. at 132-39 (determining, based in part on a finding that the debtor's business plan was overly optimistic, that a proposed plan was not feasible); *cf. In re Las Vegas Monorail Co.*, 462 B.R. 795, 801-04 (Bankr. D. Nev. 2011) (determining that proposed plan was not feasible because it failed to make appropriate provisions for capital expenditures and debt retirement).

[370] Some practitioners refer to a plan as a "cram-up" if it is imposed upon senior classes by plan proponents in a junior class and a "cramdown" if it is imposed upon junior classes. Others, including us in this outline, refer to both as "cramdown" plans.

unwilling party" (*i.e.*, a dissenting class).[371] Cramdown is a powerful and unique feature of the Bankruptcy Code that allows for a reorganization plan to be confirmed despite its rejection by one or more classes of dissenting creditors or equityholders.

Before the bankruptcy court will consider a request to cram down one or more rejecting classes, all of the confirmation requirements set forth in section 1129(a) of the Bankruptcy Code must be met, other than the acceptance of the plan by all impaired classes.[372]

In particular, even in a cramdown, section 1129(a) requires that at least one class of creditors whose claims are "impaired" has voted to accept the plan (without counting the vote of any creditor who is an "insider").[373] As a general matter, for purposes of this section, courts construe the concept of an insider somewhat liberally, finding that the term "encompasses anyone with a sufficiently close relationship with the debtor that his conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor."[374] Recently, however, in *In re Lakeridge*,[375] the U.S. Court of Appeals for the Ninth Circuit construed the term "insider" more narrowly, holding that a creditor does not become a "statutory insider" (defined by section 101(31) of the Bankruptcy Code[376]) merely because it acquired its claim from a statutory insider. The court also upheld the finding of the lower court that the creditor in question was itself not a "non-statutory insider," despite evidence of the creditor's close personal and business relationship with the insider from whom it acquired its claim. The Supreme Court affirmed the Ninth Circuit's decision on narrow procedural grounds, although

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[371] Jack Friedman, *What Courts Do to Secured Creditors in Chapter 11 Cram Down*, 14 CARDOZO L. REV. 1495, 1496 & n.1 (1993).

[372] 11 U.S.C. § 1129(b)(1).

[373] 11 U.S.C. § 1129(a)(10).

[374] *In re Lichtin/Wade, LLC*, 2012 WL 6589794, at *2 (Bankr. E.D.N.C. Dec. 18, 2012).

[375] *In re Vill. at Lakeridge, LLC*, 634 F. App'x 619 (9th Cir. 2016).

[376] 11 U.S.C. § 101(31).

Justices in concurring opinions cast doubt on aspects of the Ninth Circuit's reasoning.[377]

Cramdown under section 1129(b) requires that the plan "not discriminate unfairly . . . with respect to each class of claims or interests that is impaired under, and has not accepted, the plan."[378] The "unfair discrimination" test ensures that creditors of the same priority level are not forced to accept meaningfully different levels of risk or recovery under a plan. Although creditors of the same priority may, in some cases, be paid at different times and in different forms of consideration, courts generally will *not* allow such creditors to receive different percentage returns on their allowed claims.[379] Separately, courts also will not permit a class to receive more than payment in full under a plan that is to be crammed down over the objection of a junior class.[380]

In addition, cramdown requires that the proposed plan be "fair and equitable."[381] Whereas the "unfair discrimination" test is intended to ensure that similarly situated creditors receive similar treatment, the "fair and equitable" test is

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[377] *U.S. Bank N.A.* v. *Vill. at Lakeridge, LLC*, 138 S. Ct. 960 (2018); *id.* at 969 (Kennedy, J., concurring); *id.* at 969-73 (Sotomayor, J., concurring).

[378] 11 U.S.C. § 1129(b)(1).

[379] *In re Dow Corning Corp.*, 244 B.R. 705, 710 (Bankr. E.D. Mich. 1999) ("[A] rebuttable presumption that a plan is unfairly discriminatory will arise when there is: (1) a dissenting class; (2) another class of the same priority; and (3) a difference in the plan's treatment of the two classes that results in either (a) a materially lower percentage recovery for the dissenting class . . . or (b) regardless of percentage recovery, an allocation under the plan of materially greater risk to the dissenting class in connection with its proposed distribution."), *aff'd in pertinent part and rev'd in part on other grounds*, 255 B.R. 445 (E.D. Mich. 2000); *see also In re Aztec Co.*, 107 B.R. 585, 588-90 (Bankr. M.D. Tenn. 1989) ("[s]ection 1129(b)(1) prohibits only unfair discrimination, not all discrimination," and test examines such factors as: (1) whether discrimination is supported by a reasonable basis; (2) whether confirmation and consummation of a plan is possible without discrimination; (3) whether the debtor proposed the discrimination in "good faith"; and (4) the treatment of the classes discriminated against); *see also In re LightSquared, Inc.*, 513 B.R. 56, 100 (Bankr. S.D.N.Y. 2014) (rejecting plan that paid cash to certain creditors while paying notes of uncertain value and significant risk to a creditor of the same priority). *But see In re City of Detroit*, 524 B.R. 147, 255-56 (Bankr. E.D. Mich. 2014) (rejecting the analysis of *In re Aztec Co.*, 107 B.R. at 588-90).

[380] *In re Chemtura Corp.*, 439 B.R. 561, 592 (Bankr. S.D.N.Y. 2010) ("Courts will deny confirmation if a plan undervalues a debtor and therefore would have resulted in paying senior creditors more than full compensation for their allowed claims.").

[381] 11 U.S.C. § 1129(b)(1).

intended to preserve priorities among the different types of claims and interests, including the priority of secured claims over unsecured claims.

There are three alternative ways in which a plan can be "fair and equitable" to a holder of a secured claim: (1) the claimant retains its liens and receives deferred cash payments totaling at least the allowed amount of its claim and with a present value at least equal to its interest in the underlying collateral; (2) the claimant's collateral is sold, the claimant is allowed to credit bid and the claimant's lien attaches to the proceeds; or (3) the claimant receives the "indubitable equivalent" of its secured claim.[382]

If a plan provides that a secured creditor will retain its liens and receive deferred cash payments, the critical question becomes how to determine the value of those payments—*i.e.*, the appropriate discount rate to apply. The Bankruptcy Code is silent as to the rate of interest required to provide a secured creditor with the "present value" of its allowed secured claim. A splintered decision from the U.S. Supreme Court in the context of a chapter 13 (individual debtor) case, *Till* v. *SCS Credit Corp.*, suggests that the cramdown rate may be calculated by adjusting the prime rate (typically by a factor not to exceed 3%) based on the risks attendant to the loan.[383] Although the application of *Till* to chapter 11 cases remains uncertain, many courts have concluded that the appropriate interest rate following *Till* is the market rate if a relevant efficient market exists, and the *Till* formula rate otherwise.[384] The U.S. Court of Appeals for the Second Circuit followed suit in 2017 in the *Momentive* bankruptcy, holding that the market rate must be used where an efficient market exists and reversing lower court decisions that endorsed a formula approach.[385]

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[382] 11 U.S.C. § 1129(b)(2)(A).

[383] 541 U.S. 465 (2004) (plurality opinion).

[384] *See, e.g.*, *Bank of Montreal* v. *Official Comm. of Unsecured Creditors (In re Am. HomePatient, Inc.)*, 420 F.3d 559, 568 (6th Cir. 2005); *In re S. Canaan Cellular Invs., Inc.*, 427 B.R. 44, 78 (Bankr. E.D. Pa. 2010); *cf. In re Tex. Grand Prairie Hotel Realty, L.L.C.*, 710 F.3d 324, 337 (5th Cir. 2013) (approving use of the *Till* formula without concluding "that the prime-plus formula is the only—or even the optimal—method for calculating the Chapter 11 cramdown rate").

[385] *In re MPM Silicones, LLC*, 874 F.3d 787, 799-801 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 2653 (2018). One case followed the lower court decisions in *Momentive*, holding that *Till* does not require courts to use the rate available in an efficient market, but merely "suggests that when choosing a cramdown rate in a chapter 11 case, the court *might* want to consider the rate an efficient market would produce." *In re STC, Inc.*, 2016 WL 3884799, at *16 (Bankr. S.D. Ill. Apr.

Alternatively, a plan that provides for the sale of a creditor's collateral free and clear of the creditor's lien may be "fair and equitable," and therefore confirmable over the claimant's objection, if it provides that (i) the creditor's liens attach to the proceeds of the sale, (ii) the liens on the sale proceeds are provided for under one of the statutory alternatives, *i.e.*, through deferred cash payments (discussed in the paragraph above) or realization of an "indubitable equivalent" (discussed in the paragraph below), and (iii) the creditor is allowed to credit bid during the sale.[386] As discussed further in Part III.A.6 of this outline, the Supreme Court held in 2012 that a debtor cannot confirm a plan that provides for a creditor's collateral to be sold free and clear of the claimant's lien without allowing the secured claimant to credit bid.[387]

Finally, if a secured creditor does not retain a lien on its collateral, the plan may nonetheless be confirmed if it provides the creditor with the "indubitable equivalent" of its secured claim. One way to provide the "indubitable equivalent" of a secured claim simply is to transfer the collateral to the creditor. Alternatively, a plan may provide for substitute collateral that typically exceeds the amount of the claim.[388] Where the substitute collateral has a different risk profile, however, a court may reject the plan for lack of indubitable equivalence.[389] Similarly, a secured creditor may not be crammed down through

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7, 2016) (emphasis in original). It remains to be seen whether the formula approach will continue to be used following the Second Circuit's decision.

[386] 11 U.S.C. § 1129(b)(2)(A)(ii).

[387] *See RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank*, 566 U.S. 639 (2012).

[388] 7 COLLIER ON BANKRUPTCY ¶ 1129.04[2][c] (16th ed. 2010); *accord In re San Felipe @ Voss, Ltd.*, 115 B.R. 526, 530 (S.D. Tex. 1990) ("[A] bankruptcy court can guard against any potential instability in value or in the [substitute collateral's] market generally through the use of a margin between the value of the [substitute collateral] and the secured creditor's allowed claim."); *In re Keller*, 157 B.R. 680, 684 (Bankr. E.D. Wash. 1993) (substitute collateral was "indubitable equivalent" where creditor was given annuity as well as security interest sufficient to maintain collateral cushion of one-and-one-half times the value of her claim).

[389] In its 2012 decision in *In re River E. Plaza, LLC*, the Seventh Circuit rejected the debtor's attempt to eliminate a secured creditor's mortgage lien on real estate valued at $13.5 million by transferring that lien to substitute collateral in the form of $13.5 million in Treasury bonds. The secured creditor was substantially undersecured (it was owed $38.3 million), and rather than having its claim dealt with as partially secured and partially unsecured, it elected pursuant to section 1111(b) of the Bankruptcy Code to obtain a single secured claim for $38.3 million. Writing for the court, Judge Posner observed that "[b]anning substitution of collateral indeed makes good sense when as in the present case the creditor is undersecured, unlike a case in which he's oversecured, in which case the involuntary shift of his lien to substitute collateral is proper as

a distribution of equity in the reorganized debtor on account of its secured claim, as the courts have concluded that equity in a reorganized debtor is too speculative to constitute the "indubitable equivalent" of a secured claim.[390]

If the dissenting class is a class of *unsecured* claims or equity interests, section 1129(b)'s test for a "fair and equitable" cramdown is simpler: Each dissenting unsecured class must receive the full value of its allowed claims, or else the plan must provide that no classes junior to the dissenting class receive any distributions—a principle known as the "absolute priority rule."[391]

g. *Gifting*

A decision of the Court of Appeals for the First Circuit, *In re SPM Manufacturing Corp.*,[392] has long been invoked to justify recoveries to junior creditors in contravention of the absolute priority rule as constituting a "gift" from a senior class. *SPM* was, at a minimum, significantly limited in the Second Circuit Court of Appeals by that court's 2011 decision in *In re DBSD North America, Inc.* There, the Second Circuit considered a chapter 11 plan that distributed the bulk of the reorganized debtor's equity to certain of the debtor's secured creditors, with a relatively significant distribution going to the debtor's existing equity, while the unsecured creditors received a minimal distribution.[393] The debtor defended the making of a distribution to the old equity while unsecured creditors were left unpaid as a "gift" from the value that belonged to the secured creditors, who also

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long as it doesn't increase the risk of his becoming under-secured in the future." 669 F.3d 826, 831 (7th Cir. 2012). The court acknowledged the possibility that the substituted collateral "might . . . turn out to be more valuable than the building and thus provide . . . more security." *Id.* at 832. "But because of the different risk profiles of the two forms of collateral," the court held, "they are not equivalents, and there is no reason why the choice between them should be made for the creditor by the debtor." *Id.*

[390] *See, e.g.*, *In re @ Voss*, 115 B.R. at 529 (equity in reorganized debtor is not the "indubitable equivalent" of an allowed secured claim); *In re TM Monroe Manor Assocs., Ltd.*, 140 B.R. 298, 300-01 (Bankr. N.D. Ga. 1991) (noting "the use [in cramdown] of *equity securities in the reorganized debtor* was not contemplated in the Bankruptcy Code" (emphasis in original) and refusing to approve plan under which secured creditors would be satisfied mainly with limited partnership interests in the reorganized debtor).

[391] 11 U.S.C. § 1129(b)(2)(B)-(C).

[392] *Official Unsecured Creditors' Comm.* v. *Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305 (1st Cir. 1993).

[393] *In re DBSD N. Am., Inc.*, 634 F.3d 79, 86 (2d Cir. 2011).

were not fully paid and were senior to the unsecured creditors. The Second Circuit rejected this justification, ruling that a distribution to a junior class may not be made under a chapter 11 plan in violation of the absolute priority rule even if a senior class is enabling the distribution by giving up value to which it would otherwise be entitled.[394] The court distinguished *SPM*, reasoning that *SPM* was a chapter 7 case to which the section 1129(b) absolute priority rule does not apply and in which the "gift" was made out of the senior lenders' collateral after the court had lifted the automatic stay, meaning that the property no longer belonged to the debtor.[395] The *DBSD* court left open the possibility that "gifts" made outside of a plan may still be permissible.[396]

In the wake of *DBSD*, senior lenders have attempted to obtain the support of junior creditors or equity in other ways, including through structured dismissals and gifts of non-estate property. The Supreme Court's 2017 decision in *Czyzewski* v. *Jevic Holding Corp.* (*In re Jevic*),[397] however, has drawn both of these practices into question. In *Jevic*, the Supreme Court concluded that bankruptcy courts "may not approve structured dismissals that provide for distributions that do not follow ordinary priority rules without the consent of affected creditors."[398] In so holding, the Court reversed the decision of the Third Circuit, which had upheld the bankruptcy court's approval of a settlement and structured dismissal that granted unsecured creditors a partial recovery while skipping priority wage claims that were entitled to higher priority under section 507(a)(4). Moreover, the Court rejected the Third Circuit's reasoning that structured dismissals could be permissible in "rare" situations in which "sufficient and credible" grounds existed to justify deviation from the statutory priority rule;[399] according to the Court, "Congress did not authorize a 'rare case'

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[394] *See id.* at 100-01.

[395] *See DBSD*, 634 F.3d at 97-100; *see also In re Armstrong World Indus., Inc.*, 432 F.3d 507, 513-15 (3d Cir. 2005) (similarly concluding that a purported "gift" from an unsecured senior class of creditors to a junior class in the context of a plan ran afoul of the section 1129(b) absolute priority rule).

[396] *See DBSD*, 634 F.3d at 95-96.

[397] 137 S. Ct. 973 (2017).

[398] *Id*. at *2.

[399] *In re Jevic*, 787 F.3d 173 (3d Cir. 2015), *as amended* (Aug. 18, 2015), *rev'd sub nom. Czyzewski* v. *Jevic Holding Corp.*, 137 S. Ct. 973 (2017).

exception" and courts therefore had no warrant for implementing any such exception.[400]

Jevic and its rationale have had a significant impact on bankruptcy practice. Most directly, *Jevic* appears to have put an end to nonconsensual structured dismissals that violate the absolute priority rule. Thus, while not eliminating structured dismissals as a permissible means of resolving a chapter 11 case, the decision has made them far more difficult to implement.[401]

Beyond its specific holding, the reasoning employed in the *Jevic* decision has also drawn into question the continuing viability of priority-violating "gift plans." In a gift plan, a senior creditor "gifts" or pays an amount equivalent to part of what it would otherwise recover to a lower ranking creditor, while not paying non-consenting creditors who are senior to the creditor receiving the gift in full.[402] Although the Supreme Court did not discuss gifting to junior creditors under a plan in *Jevic*, by reinforcing the primacy of the Code's priority scheme even outside of the plan context, the decision has provided ammunition for creditors opposing such plans.[403] Even after *Jevic*, however, at least one lower court has approved a gift plan.[404]

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[400] 137 S. Ct. at 987.

[401] *Cf. In re Fryar*, 570 B.R. 602 (Bankr. E.D. Tenn. 2017) (refusing to approve settlement that provided for a distribution that would violate the absolute priority rule, citing *Jevic*).

[402] Gift plans have been approved by several courts. In *In re ICL Holding Co.*, 802 F.3d 547 (3d Cir. 2015), for example, the Third Circuit held that a group of secured creditors who were credit bidding for the assets of a bankrupt debtor in a section 363 sale could deposit $3.5 million in a trust for the benefit of unsecured creditors, even though administrative expenses would not be paid in full, without violating the absolute priority rule. The U.S. government, as an administrative claimant for a tax liability, objected to the arrangement, arguing that the cash paid by the secured lenders to the unsecured creditors was effectively an increased bid for the debtor's assets. The court disagreed, holding that the money paid directly by the secured lenders to the trust for the unsecured creditors was never property of the estate and its distribution therefore did not implicate the absolute priority rule.

[403] Objections in which the objector argues that a proposed disposition of sale proceeds violates the absolute priority rule may also arise in the context of a 363 sale. *See* Part III.A.1.b.

[404] In *In re Nuverra Environmental Solutions, Inc.*, the Delaware District Court affirmed confirmation of a chapter 11 plan premised on a gift from secured creditors—the only class that would have received any recovery under strict application of the absolute priority rule—to two classes of unsecured creditors: holders of unsecured notes and certain trade creditors. The secured creditors' gift gave favored noteholders a 4-6 percent recovery and trade creditors a 100

h. *New Value*

Potential acquirors of a debtor may encounter former equityholders or other insiders of the debtor who are attempting to retain ownership of the company. While the absolute priority rule usually results in the cancellation of old equity interests in the debtor, equityholders may invoke the "new value" exception to this rule. This judge-made exception, which developed under the former Bankruptcy Act, permitted a debtor's old equityholders to retain their equity in a bankrupt company—even when creditors were not paid in full—in exchange for an infusion of new capital into the company. Since enactment of the Bankruptcy Code, courts have held that the new value exception only "permits old equity owners to participate in a plan, without full payment to the dissenting creditors, if they make a new contribution (1) in money or money's worth, (2) that is reasonably equivalent to the value of the new equity interests in the reorganized debtor and (3) that is necessary for implementation of a feasible reorganization plan."[405]

The U.S. Supreme Court last considered the new value exception in 1999, in *Bank of America National Trust & Savings Association* v. *203 North LaSalle Street Partnership*.[406] The Court declined to rule on the validity of the new value exception, but opined that, if the exception exists, equityholders may not retain their equity in the company by investing new capital without subjecting that investment to competition and "without the benefit of market valuation."[407] The

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percent recovery. Because the objecting unsecured creditors "were not entitled to a distribution in the first place, providing a greater distribution to a different class of unsecured creditors [did] not alter the distribution to which [the objectors] were entitled," according to the district court. 590 B.R. 75 (D. Del. 2018); *see also In re Nuverra Envtl. Sols., Inc.*, No. 17-1024-RGA, 2017 WL 3326453 (D. Del. 2017) (denying stay of confirmation order and discussing objectors' likelihood of success on the merits). The objectors' appeal, which focuses on *Jevic*, is currently pending before the Third Circuit. *In re Nuverra Envtl. Sol.*, No. 18-03084 (3d Cir. filed Sept. 24, 2018).

[405] *In re Woodbrook Assocs.*, 19 F.3d 312, 319-20 (7th Cir. 1994); *see also* 7 COLLIER ON BANKRUPTCY ¶ 1129.03[4][c][i][A] (16th ed. 2010); *cf. In re G-1 Holdings Inc.*, 420 B.R. 216, 269 (D.N.J. 2009) (articulating the three factors listed above, and adding "[4] substantial and [5] proffered by the debtor at the outset, *i.e.*, up front") (internal quotation marks omitted); *see also In re Dunlap Oil Co.*, 2014 WL 6883069, at *22 (9th Cir. B.A.P. Dec. 5, 2014) (affirming ruling permitting new value contribution and holding contribution worth 5.49% of unsecured claims was sufficiently "substantial").

[406] 526 U.S. 434 (1999).

[407] *Id.* at 458 (reversing lower court's approval of plan for lack of such features).

Court did not decide what kind of market test was required, and since *LaSalle*, no clear consensus has emerged. Some lower courts have found that the market test requirement could be satisfied where the debtor co-proposed the plan with creditors holding a blocking vote,[408] an examiner's report valued the consideration received by equityholders,[409] a lockup agreement between the debtor and equityholders obligated the debtor to solicit alternative offers,[410] or the debtor's exclusive right to propose a plan of reorganization was terminated.[411] However, in 2013, the Seventh Circuit remanded a case involving new value to the bankruptcy court "with directions to open the proposed plan of reorganization to competitive bidding," stating that the rationale of *LaSalle* did not depend on whether the plan was proposed during the debtor's exclusivity period or who proposed it.[412] On remand, the bankruptcy court rejected numerous plans that retained the equityholders' stake without a competitive process, and ultimately dismissed the bankruptcy case.[413] In short, in the wake of *LaSalle*, a former equityholder of the debtor that wishes to invest in the reorganized company must be prepared to face competition from other creditors or market participants.

i. *Disclosure Requirements*

Prior to soliciting acceptances of its plan of reorganization, the plan proponent must prepare, serve on all parties in interest, and obtain bankruptcy court approval of a "disclosure statement" with respect to the plan.[414] To be approved, the disclosure statement must provide "adequate information,"[415] which the Bankruptcy Code defines as information "of a kind, and in sufficient detail" that

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[408] *See In re G-1 Holdings Inc.*, 420 B.R. at 269.

[409] *See In re PWS Holding Corp.*, 228 F.3d 224, 242 (3d Cir. 2000).

[410] *See In re Union Fin. Servs. Grp, Inc.*, 303 B.R. 390, 423-26 (Bankr. E.D. Mo. 2003).

[411] *H.G. Roebuck & Son, Inc.* v. *Alter Commc'ns, Inc.*, 2011 WL 2261483, at *8-9 (D. Md. June 3, 2011).

[412] *In re Castleton Plaza, LP*, 707 F.3d 821, 824 (7th Cir. 2013).

[413] *In re Castleton Plaza, LP*, 561 F. App'x 561 (7th Cir. 2014).

[414] 11 U.S.C. § 1125(b).

[415] *Id.*

would allow a "hypothetical investor of the relevant class to make an informed judgment about the plan."[416]

Preparing and obtaining bankruptcy court approval for a disclosure statement is rarely a significant challenge for the plan proponent if the plan proponent is the debtor. Typically, any objections made to the adequacy of disclosure are resolved by supplementing the proposed disclosure statement with additional information, including the views and positions of the objecting parties. For a plan proponent other than the debtor, however, drafting and securing approval of a disclosure statement can be a challenge, particularly if the debtor is unable or unwilling to provide its management's assistance and access to its books and records.

Although it is not uncommon for parties that intend to oppose confirmation of the plan to raise their confirmation objections at the disclosure statement hearing, bankruptcy courts will rarely consider such objections on the merits, instead deferring them to the confirmation hearing. Occasionally, a court will disapprove a disclosure statement and prevent a plan from going forward at the disclosure stage if it finds the plan to be patently nonconfirmable.[417]

The requirement that votes on a plan be solicited only in accordance with a court-approved disclosure statement can interfere with the typical prepackaged or pre-negotiated plan proponent's goal of locking creditors up to a restructuring support agreement as soon as possible. The tension between this statutory mandate and the practical objective of locking up creditors is discussed in Part III.B.10 of this outline.

j. *Obtaining Confirmation*

Once a disclosure statement is approved, the proponent of the plan may solicit acceptances of the plan by serving on all parties who are entitled to vote copies of the court-approved disclosure statement, the proposed plan and ballots. It is important that the proper procedures be used to determine who are eligible voters

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[416] *Id.* § 1125(a)(1). In determining whether "adequate information" has been provided, courts are instructed to compare the benefit of providing additional information to parties in interest against the cost of doing so. *Id.*

[417] *See, e.g.*, *In re Am. Capital Equip., LLC*, 688 F.3d 145, 144-45 (3d Cir. 2012) (holding that confirmability issues can be addressed at disclosure hearing stage and affirming bankruptcy court's rejection of disclosure statement); *In re Wong*, No. 18-17666, 2019 WL 1233698 (Bankr. D. Md. Mar. 14, 2019); *In re Arnold*, 471 B.R. 578 (Bankr. C.D. Cal. 2012), *appeal dismissed* (Jan. 16, 2013).

and to allow them enough time to vote. Plan solicitation should be directed at the actual beneficial owners rather than the record holder, analogous to the "street name" concept for normal corporate voting practices.[418]

3. Protections that Can Be Obtained from Confirmation Order

After entry of the order by the bankruptcy court confirming a chapter 11 plan, generally a 14-day period must elapse to permit any party seeking to appeal the order to file a notice of appeal and to seek a stay of the effectiveness of the order pending resolution of the appeal.[419] If no stay is obtained, then the debtor may begin to implement the plan on the 15th day, regardless of whether an appeal has been filed.

To secure a stay of a confirmation order, the appealing party generally will be required to post a bond.[420] It is difficult for a court to predict what damages might be caused by delaying confirmation, making the calculation of the amount of the bond to stay an appeal uncertain. A stay of a confirmation order will prevent creditors from receiving their anticipated distributions under the plan, and also will halt the consummation of whatever transactions were to occur pursuant to the plan, which might include the financing of the exit from bankruptcy, sales of assets, changes in corporate form and raising of new equity in the capital markets. When calculating the amount to be required to bond a confirmation appeal, courts have included as possible costs of delay the accrual of interest on postpetition debt and additional professional fees,[421] as well as various forms of consequential

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[418] *See In re Southland Corp.*, 124 B.R. 211, 227 (Bankr. N.D. Tex. 1991) ("Taking the plain words of Congress in § 1126, only the holder of a claim, or a creditor, or the holder of an interest, may accept or reject a plan. If the record holder of a debt is not the owner of a claim, or a true creditor, he may not vote validly to accept or reject, unless he is an authorized agent of the creditor, and this authority is established under appropriate Bankruptcy law and rules."); *see also* Fed. R. Bankr. P. 3018(b).

[419] Fed. R. Bankr. P. 3020(e). However, the bankruptcy court may extend, reduce or waive this 14-day period, which is not uncommon. Fed. R. Bankr. P. 9006(b)-(c).

[420] Bankruptcy and appellate courts have discretion to dispense with the bond requirement. *See* Fed. R. Bankr. P. 8007(c); *In re Sphere Holding Corp.*, 162 B.R. 639, 644-45 (E.D.N.Y. 1994); *In re Motors Liquidation Co.*, 539 B.R. 676, 686-87 (Bankr. S.D.N.Y. 2015); *see also In re Chemtura Corp.*, 2010 WL 4638898, at *5, *5 n.23 (Bankr. S.D.N.Y. Nov. 8, 2010) (discussing standards governing supersedeas bonds). In addition, the federal government cannot be required to post a bond to secure a stay of the confirmation order. Fed. R. Bankr. P. 8007(d).

[421] *See In re Tribune Co.*, 477 B.R. 465, 478-83 (Bankr. D. Del. 2012) (analyzing opportunity costs to creditors who would receive delayed distributions and loss in market value to equity

damages, most notably opportunity costs to creditors whose distributions would be delayed.[422] The cost of bonding an appeal from a confirmation order can be prohibitively expensive, and thus frequently presents a dilemma for the appellant, and a significant advantage for the successful plan proponent, as it may not be economically rational in comparison to the potential benefit to be gained from, and likelihood of success on, the appeal.

For example, in *ACC Bondholder Group* v. *Adelphia Communications Corp. (In re Adelphia Communications Corp.)*, a group of bondholders that held approximately $1 billion of the debtor's $5 billion in notes and debentures had objected to confirmation of the plan.[423] The district court granted the bondholders' request for a stay pending appeal of the confirmation order, but set the bond requirement at $1.3 billion, to be posted within 72 hours. The bondholders then sought further appellate review of the bond requirement, arguing that the setting of such a high bond amount was in essence a denial of the stay. The bondholders, however, "did not (and could not) claim that they were *unable* to post [the required] amount. Rather, their position was that the posting of a bond in that amount would be an imprudent business decision for their clients."[424] The Court of Appeals for the Second Circuit dismissed the appeal of the bond amount, and the bondholders returned to the district court to seek modification of the bond amount. After the appellants offered to post only $10

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investors caused by delayed emergence); *In re Adelphia Commc'ns Corp.*, 361 B.R. 337, 352-53 (S.D.N.Y. 2007) (debtors estimated $70 million per month in interest costs and $10 million per month in professional fees), 2007 WL 7706743 (2d Cir. 2007); *In re Pub. Serv. Co. of N.H.*, 116 B.R. 347, 350 (Bankr. D.N.H. 1990) (noting that a potential supersedeas bond would have to include accruing interest, as well as various other costs of delay).

[422] *See In re Motors Liquidation Co.*, 539 B.R. 676, 687 (Bankr. S.D.N.Y. 2015); *see also In re Calpine Corp.*, 2008 WL 207841, at *5, *7 (Bankr. S.D.N.Y. Jan. 24, 2008) (explaining that granting a stay would threaten the existing exit financing and a bond would have to include additional interest expense that would result from the debtors' need to acquire alternative exit financing), *appeal denied*, 390 B.R. 508 (S.D.N.Y 2008), *aff'd*, 354 F. App'x 479 (2d Cir. 2009); *see also Lynch* v. *Cal. Pub. Utils. Comm'n*, 2004 WL 793530, at *3-4 (N.D. Cal. Apr. 9, 2004) (denying stay of confirmation order in part as a result of numerous financial harms to the debtor that would result from a stay, including risk to the debtor's exit financing and the associated potential need to raise alternative financing, the obligation to pay an additional $1.7 million per day in interest costs to existing creditors, and the possibility of having to return the proceeds of recently sold bonds and pay substantial redemption premiums).

[423] 367 B.R. 84 (S.D.N.Y. 2007).

[424] *Id.* at 89.

million at the hearing on the modification issue, the court vacated the stay and the plan became effective.[425]

Nevertheless, the bondholders attempted to proceed with their appeal on the merits even after the plan became effective. The district court dismissed the appeal, however, concluding both that the bondholders were estopped from asserting that their appeal was not moot[426] and that, even if they were not so estopped, the effectiveness and consummation of the plan had rendered their appeal equitably moot. In so doing, the court took particular note of the bondholders' unwillingness to post a bond in an amount greater than $10 million, which it characterized as "a complete refusal to post a reasonable bond."[427]

"Equitable mootness" is a doctrine that can provide another significant advantage to a successful plan proponent, as illustrated by *Adelphia*. The doctrine essentially arises from the fact that implementation of a plan often involves complex transactions that, once done, are difficult to undo as a practical matter. Applying this doctrine, appellate courts will often decline to reach the merits of an appeal of an unstayed confirmation order based upon the impracticality and inequity of "unscrambl[ing]" transactions that were already implemented pursuant to the confirmation order.[428] The Second Circuit has gone even further, finding in *In re Charter Communications, Inc*. that an "appeal is presumed equitably moot where the debtor's plan of reorganization has been substantially

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[425] *Id*. at 89-90.

[426] The court had previously granted a stay of the confirmation order based on the bondholders' representation that the appeal would be equitably moot absent a stay. This representation, the court concluded, prevented the bondholders from changing positions on equitable mootness now.

[427] *Id*. at 98-99.

[428] *In re Cont'l Airlines*, 91 F.3d 553, 566 (3d Cir. 1996) (en banc); *see, e.g., In re Phila. Newspapers, LLC*, 690 F.3d 161, 169 (3d Cir. 2012) (courts should only "apply the equitable mootness doctrine if doing so will '[unscramble] complex bankruptcy reorganizations when the appealing party should have acted before the plan became extremely difficult to retract'"); *In re SemCrude, L.P.*, 728 F.3d 314, 321 (3d Cir. 2013) ("In practice, it is useful to think of equitable mootness as proceeding in two analytical steps: (1) whether a confirmed plan has been substantially consummated; and (2) if so, whether granting the relief requested in the appeal will (a) fatally scramble the plan and/or (b) significantly harm third parties who have justifiably relied on plan confirmation."); *see also, e.g., In re Idearc, Inc.*, 662 F.3d 315 (5th Cir. 2011); *In re Metromedia Fiber Network, Inc.*, 416 F.3d 136, 145 (2d Cir. 2005).

consummated."[429] Coupled with the Second Circuit's adoption of an abuse of discretion standard of review for equitable mootness determinations made by district courts, parties in the Second Circuit likely face a difficult path in appealing a substantially consummated plan.[430]

However, certain appellate court decisions have called the doctrine of equitable mootness into question, at least in smaller cases involving debtors with relatively few creditors and uncomplicated capital structures, where unwinding a plan would be less onerous. One Third Circuit judge has even gone so far as to urge courts, in a concurring opinion, "to consider eliminating, or at the very least, reforming, equitable mootness," calling the doctrine an "experiment" that has resulted in "abdication" of appellate jurisdiction.[431]

Where the characteristics of a particular plan are such that a stay will be granted only if a prospective appellant posts a prohibitively large bond, it may be practically impossible to obtain appellate review prior to plan effectiveness and the accompanying consummation of the transactions contemplated in the plan. As a result, the mere confirmation of certain plans may effectively immunize them from review.

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[429] 691 F.3d 476, 482 (2d Cir. 2012) (emphasis added). Such presumption can be overcome in the Second Circuit if *all* of the following five factors are met: (1) the court can still order some effective relief; (2) such relief will not affect the reemergence of the debtor as a revitalized corporate entity; (3) such relief will not unravel intricate transactions so as to knock the props out from under the authorization for every transaction that has taken place and create an unmanageable, uncontrollable situation for the Bankruptcy Court; (4) the parties who would be adversely affected by the modification have notice of the appeal and an opportunity to participate in the proceedings; and (5) the appellant pursued with diligence all available remedies to obtain a stay of execution of the objectionable order if the failure to do so creates a situation rendering it inequitable to reverse the orders appealed from. *In re Chateaugay Corp.*, 10 F.3d 944, 952-53 (2d Cir. 1993); *see, e.g.*, *Ahuja* v. *LightSquared Inc.*, 644 F. App'x 24 (2d. Cir. 2016) (finding appeal was not equitably moot, even though chapter 11 plan had been substantially consummated, where (i) appellant had diligently sought a stay in bankruptcy court, district court, and on appeal, and had moved for expedited appeal, (ii) parties that would be adversely affected had notice of appeal and opportunity to participate in the proceedings, and (iii) it was still possible for court to afford some monetary relief).

[430] *Id*. at 483.

[431] *In re One2One Comms., LLC*, 805 F.3d 428, 438-39 (3d Cir. 2015) (Krause, J., concurring); *see also id*. at 436-37 (majority opinion) (declining to apply doctrine in absence of "intricate transactions"); *In re Transwest Resort Props., Inc.*, 801 F.3d 1161, 1173 (9th Cir. 2015) (declining to apply equitable mootness where appellant diligently sought stay and remedy that would not unduly harm third parties could be devised).

4. Advantages of Chapter 11—Ability to Purchase Assets Under a Plan Free and Clear of Liabilities

As an alternative to a sale during a chapter 11 case pursuant to section 363, discussed in Part III.A of this outline, a debtor may sell some or all of its assets pursuant to a plan of reorganization. One advantage to an acquiror of assets under a plan is that the acquiror can benefit from the theoretically more expansive discharge of "claims" that a debtor obtains under a confirmed plan of reorganization than from an order approving a sale under section 363. In practice, however, orders approving section 363 sales typically provide for broad and comprehensive preclusions of liability such that any difference in the scope of relief between a plan and a section 363 order is relatively slight. The applicable scope of the discharge of claims available under a confirmed chapter 11 plan is of particular interest to a plan investor or acquiror because (like the permitted parameters of a section 363 sale order) it defines the purchaser's ability to "cleanse" with judicial finality the acquired assets from and against pre-bankruptcy claims and interests.

As discussed in Part III.A, a sale pursuant to section 363 is "free and clear of any *interest* in such property."[432] The discharge afforded by a chapter 11 plan, however, is established by section 1141(c) of the Bankruptcy Code, which states that "after confirmation of a plan, *the property dealt with by the plan is free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor*."[433] The term "claims," which defines what can be discharged as part of a plan, is generally understood to be somewhat broader than the term "interests" in a section 363 sale.[434]

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[432] 11 U.S.C. § 363(f) (emphasis added).

[433] 11 U.S.C. § 1141(c) (emphasis added).

[434] *Cf.* 11 U.S.C. § 101(5) ("The term 'claim' means . . . (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment. . . ."). At least one appellate court has conflated the two terms by reading the term "claim" into the scope of 363(f). *See Al Perry Enters.* v. *Appalachian Fuels, LLC*, 503 F.3d 538, 543 (6th Cir. 2007) ("The bankruptcy court has clear power to approve the sale of debtors' assets free and clear *of any interest or claims* . . . pursuant to 11 U.S.C. § 363(f)." (emphasis added)); *see also In re Chrysler LLC*, 576 F.3d 108, 125 (2d Cir. 2009) ("Given the expanded role of § 363 in bankruptcy proceedings, it makes sense to harmonize the application of § 1141(c) and § 363(f) to the extent permitted by the statutory language."), *vacated as moot, Ind. State Police Pension Tr.* v. *Chrysler LLC*, 558 U.S. 1087 (2009). *See generally* Part III.A.2.a.iii.C.i.

Even with the greater breadth of "claims" that are discharged under section 1141, however, as discussed below, there remains a risk that existing claims of creditors that did not receive adequate notice of the bankruptcy, or claims that had not yet arisen at the time of the sale, could still be asserted against a purchaser of assets pursuant to a confirmed plan, notwithstanding the discharge by the bankruptcy court.

a. *Notice*

Both the Bankruptcy Rules and constitutional due process require notice to a claimant to discharge a claim.[435] Notice becomes problematic with claimants that cannot be located, as well as with claims that may arise in the future.[436] Courts have held, however, that notice published in newspapers with wide circulation may be sufficient to overcome due process issues as to claimants "whose interests or whereabouts could not with due diligence be ascertained."[437] However, as discussed above, the court in the General Motors bankruptcy held that ignition switch claimants had not been given adequate notice of the requirement that they file claims.[438] While acknowledging that publication notice is generally adequate

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[435] *See, e.g.*, Fed. R. Bankr. P. 4004(a); *Zurich Am. Ins. Co.* v. *Tessler (In re J.A. Jones, Inc.)*, 492 F.3d 242, 249-51 (4th Cir. 2007); *Morgan Olson, L.L.C.* v. *Frederico (In re Grumman Olson Indus., Inc.)*, 467 B.R. 694, 706-07 (S.D.N.Y. 2012) (discussing constitutional due process requirements of notice in the section 363 context).

[436] *See, e.g.*, *In re Gen. Motors Corp.*, 407 B.R. 463, 506-07 (Bankr. S.D.N.Y. 2009) (recognizing constitutional problem in the section 363 context regarding notice to claimants who did not yet know if they had asbestos-related injuries stemming from the debtors' conduct), *aff'd sub nom*, *In re Motors Liquidation Co.*, 428 B.R. 43 (S.D.N.Y. 2010).

[437] *J.A. Jones*, 492 F.3d at 250 (quoting *Mullane* v. *Cent. Hanover Bank & Tr. Co.*, 339 U.S. 306, 317 (1950)); *see also In re Chrysler LLC*, 405 B.R. 84, 111 (S.D.N.Y.), *stay granted sub nom*, *Ind. State Police Pension Tr.* v. *Chrysler LLC*, 129 S. Ct. 2275 (Mem), *stay vacated*, 556 U.S. 960 (2009); *In re US Airways, Inc.*, 2008 WL 850659, at *5-6 (Bankr. E.D. Va. Mar. 27, 2008) (approving notice by publication in connection with discharge following confirmation of chapter 11 plan).

[438] *See* Part III.A.2.a.iii.C.i. The bankruptcy court also held, however, that the claimants' interests had been adequately represented—*i.e.*, that they had suffered no prejudice as a result of the lack of notice. This conclusion was reversed by the Second Circuit on appeal. 829 F.3d 135, 163-66 (2d Cir. 2016).

for *unknown* claimants, the bankruptcy court held that the ignition switch claimants were *known* claimants based on Old GM's knowledge of the defect.[439]

b. *Future Claims—Mass-Tort Cases*

"Future claims" are claims that have not yet arisen, held by claimants whose identities are not yet known. The future claims issue arises most frequently in the tort context, where companies that have manufactured a defective product that may still cause injuries in the future files a bankruptcy case, seeking to resolve all of its potential liability. The obvious dilemma in these cases is how to provide notice to as-yet-unknown claimants, who may not yet have suffered any injury. Many cases have allowed for the resolution of all potential liability from a mass tort, including future claims, but there are limits on how far the courts have been willing to go. A potential acquiror interested in purchasing a company that has mass tort exposure should be aware that bankruptcy will not obviate the debtor's need to pay these liabilities, though it may allow them to be effectively siloed off and paid in accordance with a chapter 11 plan.

Courts have addressed the problem of providing notice to unknown claimants in the chapter 11 plan context by appointing a representative for the holders of likely future claims and establishing a fund for the treatment of such claims under a plan of reorganization.[440] The future claims representative acts as a representative of the interests of persons who are likely in the future to have claims based on acts already committed by a debtor.[441] In addition, the court may create a claims trust that, when coupled with a "channeling injunction," effectively limits most tort claimants' recoveries to trust assets.[442] In such circumstances, the bankruptcy court will estimate the amount necessary to fund the trust based on the expected

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[439] *See In re Motors Liquidation Co.*, 529 B.R. 510, 556-60 (Bankr. S.D.N.Y. 2015), *aff'd in part, rev'd in part*, 829 F.3d at 135.

[440] *See, e.g.*, *In re A.H. Robins Co.*, 88 B.R. 742, 743-48 (E.D. Va. 1988) (use of future claims representative for persons injured by Dalkon Shield contraceptive device), *aff'd*, 880 F.2d 694 (4th Cir. 1989); *see also* Frederick Tung, *The Future Claims Representative in Mass Tort Bankruptcy: A Preliminary Inquiry*, 3 CHAP. L. REV. 43, 50-52 (2000) (discussing the "mass tort debtor").

[441] *See, e.g.*, *In re Forty-Eight Insulations, Inc.*, 58 B.R. 476, 476-77 (Bankr. N.D. Ill. 1986); *In re Johns-Manville Corp.*, 36 B.R. 743, 757-59 (Bankr. S.D.N.Y. 1984), *aff'd*, 52 B.R. 940 (S.D.N.Y. 1985).

[442] *See, e.g.*, *A.H. Robins*, 88 B.R. at 751; *Kane* v. *Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988).

amount of claims against the debtor.[443] The trust is then funded with the debtor's assets, which may include proceeds of 363 sales. For asbestos claims specifically, an elaborate set of specialized rules has been codified in section 524(g) of the Bankruptcy Code.[444]

However, not all claims against a debtor may be cut off by a 363 sale or confirmation of a chapter 11 plan. For example, the right to equitable enforcement of a covenant not to compete, available only where damages are not an adequate remedy for breach of the covenant, will survive a bankruptcy discharge.[445] Moreover, claims arising from post-confirmation events may be asserted against the reorganized debtor.[446]

Certain claimants that were unable to participate in the bankruptcy case due to lack of notice may be able to assert successor liability against an asset purchaser.[447] In general, whether claims against the debtor are dischargeable is determined by whether they have sufficiently "ripened" prepetition. Most courts[448] now apply the "conduct" test: a claim is ripe—and, therefore, may be dealt with in a plan or discharged in bankruptcy—once the acts giving rise to the claim have occurred. Many courts require, in addition, that there was a

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[443] *See* 11 U.S.C. § 502(c).

[444] Section 524(g) also contains a provision allowing injunctions barring actions against non-debtor third parties whose liability arises "by reason of" a relationship between the debtor and the third party. These relationships include an ownership interest in or managerial involvement with the debtor. However, the Second Circuit has limited the use of this provision to cases where the third party's liability was "a legal consequence" of such enumerated relationships. *In re Quigley Co.*, 676 F.3d 45, 62 (2d Cir. 2012). As such, bankruptcy courts' ability to shield solvent parent companies from asbestos-related tort liabilities is somewhat limited.

[445] *See Kennedy* v. *Medicap Pharm., Inc.*, 267 F.3d 493, 496-98 (6th Cir. 2001).

[446] *In re Kewanee Boiler Corp.*, 198 B.R. 519, 528 (Bankr. N.D. Ill. 1996).

[447] *See Morgan Olson, LLC* v. *Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243, 251-54 (Bankr. S.D.N.Y. 2011) (where plaintiff suffered postpetition injuries from defective product manufactured by the debtor prior to the petition date, asset purchaser could be held liable notwithstanding free-and-clear sale under section 363(f)), *aff'd*, 467 B.R. 694 (S.D.N.Y. 2012). *See also* Part III.B.4.b.

[448] *See Saint Catherine Hosp. of Ind.* v. *Ind. Family & Soc. Servs. Admin.*, 800 F.3d 312 (7th Cir. 2015) ("[V]irtually all courts now apply some version of the 'conduct test.'").

prepetition relationship between the debtor's conduct and the claimant.[449] A claim may thus be ripe for bankruptcy purposes even if the injury has not yet manifested itself.[450]

For example, the influential case of *Epstein* v. *Official Committee of Unsecured Creditors (In re Piper Aircraft Corp.)* involved an aircraft manufacturer that had been named in lawsuits alleging that its products were defective and caused airplane crashes.[451] When the company filed for bankruptcy, the bankruptcy court appointed a representative for future tort claimants who filed a large claim based on statistical assumptions regarding the number of people likely to be injured or killed in future plane crashes. The court concluded that claims asserted on behalf of the unidentifiable individuals who had not yet been injured by, or even exposed to, the debtor's products prior to confirmation of a plan, were not yet ripe and so could not be dealt with in the chapter 11 plan.[452]

An acquiror of a company with significant mass tort or other long-tailed liabilities (such as environmental or product-related liabilities) must analyze carefully the distinctive problems the future claims may pose in order to maximize the protection of a bankruptcy discharge for the assets to be acquired. This is a particularly acute problem where a selling debtor will be liquidated following the acquisition. As noted, a potential solution for a purchaser in such situations is to require that a fund be created to satisfy estimated future claims liabilities.

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[449] *See, e.g.*, *Epstein* v. *Official Comm. of Unsecured Creditors (In re Piper Aircraft Corp.)*, 58 F.3d 1573 (11th Cir. 1995) (a "claim" should only be dealt with by a plan if: "(i) events occurring before [plan] confirmation create a relationship, such as contact, exposure, impact, or privity, between the claimant and the debtor's product; and (ii) the basis for liability is the debtor's prepetition conduct in designing, manufacturing and selling the allegedly defective or dangerous product"). *But see In re Jensen*, 995 F.2d 925, 930-31 (9th Cir. 1993) (requiring that the "claim" was within "fair contemplation of the parties" at the time of bankruptcy).

[450] Because the focus is on the debtor's conduct, rather than manifestation of the injury, a claim may be ripe for bankruptcy purposes even before the claimant would have a cause of action under state law. *See In re Chi., Milwaukee, St. Paul & Pac. R.R. Co.*, 6 F.3d 1184 (7th Cir. 1993).

[451] 58 F.3d at 1573.

[452] *Id*. at 1577-78. This test is commonly known as the "relationship test." *See, e.g.*, *In re Chateaugay Corp.*, 944 F.2d 997, 1003-04 (2d Cir. 1991); *Olin Corp.* v. *Riverwood Int'l Corp. (In re Manville Forest Prods. Corp.)*, 209 F.3d 125, 129 (2d Cir. 2000); *Lemelle* v. *Universal Mfg. Corp.*, 18 F.3d 1268, 1276-77 (5th Cir. 1994).

5. Another Advantage of Chapter 11—Potential Ability to Restructure Indebtedness of Special Purpose Entities

It is not uncommon for a business to organize its capital structure such that significant portions of its overall debt are incurred by one or more subsidiaries created solely for the purpose of incurring such debt, which is secured only by those subsidiaries' own assets.[453] A subsidiary of this type is commonly referred to as a "special-purpose entity" or "SPE."[454]

The loan documents for borrowing by an SPE generally preclude the SPE from incurring additional debt, selling assets, changing its organizational structure, merging or consolidating with another entity, or liquidating. These restrictions are intended to ensure that the value of the SPE's assets remains in the SPE and to prevent the SPE from becoming insolvent absent a decrease in the value of its assets. SPE loan documents also commonly include so-called "bankruptcy remoteness" covenants, which are intended to prevent the SPE's assets and liabilities from being consolidated with those of its parent and affiliates in a bankruptcy. Among other things, these covenants generally require the SPE to conduct its business affairs separately from its parent and affiliates, and to retain at least one independent director or manager whose consent is required to file the SPE for bankruptcy.[455]

In the past, the provisions described above were commonly believed to ensure both that the value of an SPE's assets would remain with the SPE and that the SPE would not be drawn into a bankruptcy case of its parent or substantively consolidated with its parent in such a proceeding. Accordingly, lenders to an SPE generally had little incentive to consent to restructuring its obligations, even if doing so would alleviate the financial distress of the SPE's parent.

The 2009 decision in *In re General Growth Properties, Inc.*, however, suggests that a parent-debtor may be able to file its SPE subsidiaries for bankruptcy, notwithstanding any "bankruptcy remoteness" covenants, and thereby facilitate

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[453] Arrangements of the type described here are commonly used in securitizations of assets. *See* Steven L. Schwarcz, *The Alchemy of Asset Securitization*, 1 STAN. J. L. BUS. & FIN. 133, 135 (1994).

[454] *See* David B. Stratton, *Special Purpose Entities and Authority to File Bankruptcy*, AM. BANKR. INST. J., Mar. 2004, at 36, https://www.abi.org/abi-journal/special-purpose-entities-and-authority-to-file-bankruptcy.

[455] *See id.*

restructuring of SPE debt.[456] In that case, the parent-debtor, which had defaulted under its credit facilities, filed a bankruptcy petition and also caused a large number of its SPE subsidiaries—which had not defaulted—to file as well (in many cases, after replacing their existing independent directors with other persons amenable to such filings). The bankruptcy court refused to dismiss the petitions of the SPE subsidiaries as having been filed in bad faith, concluding, among other things, that in determining to file a bankruptcy petition, an entity need not itself face imminent default; rather, the extent of its financial distress may be evaluated from the perspective of a parent-debtor and its subsidiaries considered as a whole. The court also determined that the refusal of the lenders to the SPE subsidiaries to accede to any plan of reorganization did not render a bankruptcy proceeding futile and that the various filing entities had not demonstrated subjective bad faith by replacing their independent directors. The bankruptcy court expressly disclaimed any implication that General Growth's SPE subsidiaries would or should be substantively consolidated with the parent-debtor, suggesting that most of the protections that the SPE structure is generally believed to afford lenders would remain in place.[457] Nevertheless, the lenders to the SPE subsidiaries, which had previously been unwilling to restructure the SPE subsidiaries' debt, agreed to such a restructuring shortly thereafter.[458] The ability to draw SPEs into bankruptcy may provide a debtor, or a potential purchaser, with sufficient leverage to cause lenders to agree to restructuring the debt of SPE subsidiaries, or even make it possible to force a restructuring on non-consenting lenders if consistent with applicable bankruptcy law.

An additional feature of some SPE transactions is also noteworthy: To mitigate their potential for loss upon a bankruptcy filing involving an SPE, lenders to an SPE may seek guarantees from the SPE's parent or sponsor that only spring to life

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[456] *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[457] *See id.* at 69. A more recent case out of the Northern District of Illinois upheld many of the substantive protections of a bankruptcy remote vehicle, finding that the assets of the SPE were acquired in a "true sale" from the parent, and that the SPE was sufficiently separate from the parent, such that the SPE's assets were not property of the parent's bankruptcy estate. *Paloian* v. *LaSalle Bank Nat'l Ass'n (In re Doctors Hosp. of Hyde Park, Inc.)*, 507 B.R. 558, 708-22 (Bankr. N.D. Ill. 2013).

[458] *Compare Gen. Growth*, 409 B.R. at 53-54 (discussing failed attempts to restructure SPE subsidiaries' debt), *with In re Gen. Growth Props., Inc.*, No. 09-11977 (ALG) (Bankr. S.D.N.Y. Dec. 15, 2009), ECF No. 3915 (confirming plan restructuring SPE subsidiaries' debt).

if the SPE takes certain actions, including commingling funds with the parent,[459] amending the SPE's articles of incorporation,[460] declaring its insolvency in writing,[461] or filing for bankruptcy. When triggered, these "springing recourse guarantees," known colloquially as "bad boy guaranties," make what is otherwise a non-recourse loan to the SPE, secured only by the SPE's assets, into joint and several obligations of the SPE and its guarantors. A bad boy guaranty is especially significant when the contingent guarantor (*e.g.*, a real-estate developer) otherwise is solvent and would not itself file for bankruptcy.

Courts have wrestled with whether an SPE's mere insolvency—typically, due to deterioration in the value of the property held by the SPE—can trigger liability for its principals under a bad boy guaranty tied to certain bankruptcy remoteness covenants. One such case, *Wells Fargo Bank, N.A.* v. *Cherryland Mall LP*,[462] involved a mortgage loan backed by the Cherryland shopping mall and subject to a bad boy guaranty from the developer. When Cherryland defaulted on the mortgage, the lender sued the developer on the guarantee. The note, mortgage, and guarantee were all governed by Michigan law and provided that the loan would become fully recourse to the guarantor in the event that Cherryland breached a covenant that it "is and will remain solvent and . . . will pay its debts and liabilities . . . from its assets as the same shall become due."[463] The court held that the developer was liable for the deficiency in the lenders' recovery upon foreclosure, merely because the Cherryland SPE had failed to "remain solvent." The court noted that such a result "seems incongruent with the perceived nature of a nonrecourse debt,"[464] as it would always lead to guarantor liability unless the

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[459] *Blue Hills Office Park LLC* v. *J.P. Morgan Chase Bank*, 477 F. Supp. 2d 366, 382 (D. Mass. 2007) (guaranty triggered when company breached SPE covenants by commingling funds with parent).

[460] *LaSalle Bank N.A.* v. *Mobile Hotel Props.*, 367 F. Supp. 2d 1022, 1029-30 (E.D. La. 2004) (guaranty triggered when company breached SPE covenants by amending its articles of incorporation).

[461] *See, e.g.*, *DB Zwirn Special Opportunities Fund, L.P.* v. *SCC Acquisitions, Inc.*, 74 A.D.3d 530, 532-33 (N.Y. App. 1st Dep't 2010) (guaranty not triggered when issuer sent lender financial statements showing greater liabilities than assets because only an actual, express admission of insolvency would trigger nonrecourse carveout).

[462] 812 N.W.2d 799 (Mich. App. 2011).

[463] *Id.* at 808.

[464] *Id*. at 815.

lenders recover in full. Nevertheless, the court felt compelled by the documents as written to find the developer liable.[465] Since *Cherryland*, at least one court applying New York law has found that a similar bad boy guaranty did not trigger recourse liability to the property's sponsors upon the SPE's insolvency.[466] Nevertheless, given the uncertainty about how these provisions will be interpreted, potential acquirors of businesses with significant SPE debt should be mindful of any related guarantees.

6. Another Advantage of Chapter 11—Exemption from Registration for Securities Issued Under a Plan

Section 1145 of the Bankruptcy Code affords a useful and important exemption to the application of the federal securities laws to the debt and equity securities issued under a reorganization plan.

a. *Scope of the Exemption*

Section 1145(a) exempts securities of a debtor (or its affiliate or successor) distributed under a plan in exchange for claims against, or interests in, the debtor from the requirement to register securities under the Securities Act and state blue-sky laws.[467] Thus, creditors that receive securities as part of a reorganization plan may resell those securities even though the debtor issued them without an effective registration statement. The existence of this exemption "promotes

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[465] *Id.*; *see also 51382 Gratiot Ave. Holdings, LLC* v. *Chesterfield Dev. Co., LLC*, 835 F. Supp. 2d 384, 394-97 (E.D. Mich. 2011) (finding that because terms of contract were "unambiguous," commercial mortgage loan became fully recourse when shopping mall it was secured by became insolvent or unable to pay its debts as they became due). Shortly after *Cherryland* and *Chesterfield* were decided, the Michigan legislature passed the Nonrecourse Mortgage Loan Act to eliminate the possibility that a bad boy guaranty would be interpreted this way again in Michigan. *See* S.B. 992, 96th Leg., Reg. Sess., Pub. Act 67 (Mich. 2012), http://www.legislature.mi.gov/documents/2011-2012/publicact/pdf/2012-PA-0067.pdf. But the perceived need for a legislative solution leads to perhaps greater uncertainty in other jurisdictions where such laws have not been adopted.

[466] *Wells Fargo Bank, N.A.* v. *Palm Beach Mall, LLC*, 2013 WL 6511651, at *4, *6 (Fla. Cir. Ct. Dec. 6, 2013) (rejecting as "untenable" the interpretation that the loan became recourse merely because the value of the property fell below the loan balance—*i.e.*, the SPE became "balance-sheet" insolvent), *aff'd*, 177 So. 3d 37 (Fla. Dist. Ct. App. 2015).

[467] *See, e.g.*, *In re Pac. Shores Dev., Inc.*, 2011 WL 778205, at *5 (S.D. Cal. 2011); *In re Treasure Bay Corp.*, 212 B.R. 520, 545 (Bankr. S.D. Miss. 1997); *In re Kenilworth Sys. Corp.*, 55 B.R. 60, 62 (Bankr. E.D.N.Y. 1985); 8 COLLIER ON BANKRUPTCY ¶ 1145.02[1] (16th ed. 2010).

creditor acceptance of reorganization plans by allowing certain creditors to accept a reorganization with a view to reselling securities obtained under the plan."[468]

b. *The Underwriter Exception*

While section 1145(a) exempts from registration securities received "in exchange for a claim against, an interest in, or a claim for an administrative expense in the case concerning, the debtor," the exemption is not available to an underwriter. For these purposes, an entity is an underwriter if, among other things, it either:

> (A) purchases a claim against, interest in, or claim for an administrative expense in the case concerning, the debtor, if such purchase is *with a view to distribution* of any security received or to be received in exchange for such claim or interest; [or] . . . (D) is an issuer, as used in section 2(a)(11) [of the Securities Act], with respect to such securities.[469]

Case law interpreting the underwriter exception to the section 1145(a) exemption is sparse and, as discussed below, the exception's scope is subject to debate.

(i) Purchase of Claims with a View to Distribution

Current law is unsettled as to whether the underwriter exception in section 1145(b) should deprive purchasers of distressed debt claims of the protection of section 1145(a)'s securities registration exemption.

Some practitioners take the view that, on its face, section 1145(b)(1)(A) "would appear to remove purchasers of distressed debt, whether or not a security, at discounted prices from the safe harbor of section 1145(a)."[470] Even the proponents of this view recognize that "section 1145(b)(1)(A)'s focus on post-reorganization securities may indicate that Congress's only interest in the application of the federal securities laws to the acquisition of claims in bankruptcy cases was in the limited, post-confirmation context. Moreover, section 1145(b)(1)(A) does not appear ever to have been used against an investor in

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[468] *Kenilworth Sys.*, 55 B.R. at 62.

[469] 11 U.S.C. § 1145(b)(1) (emphasis added).

[470] Hon. Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 AM. BANKR. INST. L. REV. 569, 600 (2002).

distressed securities, and the only case to have construed the underwriter exception applied it narrowly."[471]

Other practitioners take a less restrictive view: Whether a recipient of securities on account of acquired claims qualifies as an underwriter should depend on when and for what purpose the claims were acquired. Thus, because section 1145(b)(1)(A) only includes within the definition of underwriter "those who purchase claims or stock 'with a view to distribution of any security *received or to be received*,'" a postpetition investor should retain the protection of the safe harbor of section 1145(a), so long as the investor "purchase[d] prior to the filing of a plan providing for the issuance of securities, [without] some particular knowledge that securities were to be issued."[472] According to this logic, "[i]f the postpetition investor purchased claims or stock before there was any indication that securities would be issued on account of such claims or stock, . . . the investor can hardly be said to have purchased with a view to distribution."[473] Of course, if the investor purchased claims after the plan was filed and with a view to obtaining distribution of the security, under this view, the investor would fall outside of section 1145(a)'s "safe harbor" based upon section 1145(b)(1)(A).

Thus, investors who regularly acquire distressed debt for purposes of obtaining control of the debtor through the issuance of securities under a plan should be aware that the law and practice presently are unclear as to the scope of the underwriter exception to section 1145(a), and such investors should consult with counsel regarding the possible advisability of complying with registration requirements of the federal securities laws.

(ii) The Definition of "Issuer"

Section 1145(b)(1)(D) provides that an entity is an "underwriter" for purposes of the statute if it is an "issuer" for purposes of section 2(a)(11) of the Securities Act. This provision has the potential to yield an odd result: If a debtor, in its capacity as the "issuer" of new securities, is covered by the section 1145(b)(1)(D) definition of "underwriter," then the exemption from registration offered by

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[471] *Id.*; *see also Kenilworth Sys.*, 55 B.R. at 62 ("[L]egislative history reveals that [section] 1145 was not intended to draw 'technical' underwriters into the same net as 'real' underwriters.").

[472] 6 COLLIER BANKRUPTCY PRACTICE GUIDE § 94.09 (2014).

[473] *Id.*

section 1145(a) would not extend to the debtor, thus defeating the purpose of the provision.

Rather than accepting this result, which would render section 1145(a) ineffectual, courts have construed section 1145(b)(1)(B) to include as underwriters only control persons and not the debtor itself.[474] This reading of the statute is supported by section 2(a)(11) of the Securities Act, in which the portion relevant to the definition of "issuer" indicates only that the term shall include, among others, "any person directly or indirectly controlling . . . the issuer."[475]

The legislative history of section 1145 indicates that any creditor receiving 10% or more of the relevant securities is a "control person" who should not be able to enjoy the section 1145(a) safe harbor.[476] The SEC, however, has never embraced the 10% test and has, instead, suggested that it will look at all of the facts in a case-by-case control analysis.[477] Whether or not a straight percentage ownership test is used, however, "ultimately the size of the security holding in relation to the size of the issue will have a significant effect on the determination of underwriter status."[478]

c. *Exemption of Prepetition Solicitation*

As discussed in greater detail in Part II.A.2 of this outline, while section 1145 "provides a clear safe harbor for the actual issuance of . . . new securities under [a] confirmed prepackaged plan,"[479] there is uncertainty as to whether prepetition solicitation activity for a chapter 11 plan that contemplates the issuance of securities—routinely an element of prepackaged plans—is exempted from registration by section 1145.

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[474] *See, e.g.*, *In re Standard Oil & Expl. of Del., Inc.*, 136 B.R. 141, 148-50 (Bankr. W.D. Mich. 1992); 8 COLLIER ON BANKRUPTCY § 1145.03[3][d][ii].

[475] 15 U.S.C. § 77b(a)(11); *cf.* 15 U.S.C. § 77b(a)(4) (providing the primary definition of the term "issuer").

[476] *See* COLLIER BANKRUPTCY PRACTICE GUIDE § 94.09 (2009).

[477] *See, e.g.*, Drain & Schwartz, *supra* note 459, at 599 n.183.

[478] COLLIER BANKRUPTCY PRACTICE GUIDE § 94.09 (2014).

[479] Kurt A. Mayr, *Enforcing Prepackaged Restructurings of Foreign Debtors Under the U.S. Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 469, 501 (2006).

d. *When Registration May Be Advisable*

While the relative paucity of case law applying section 1145 and the fact-based analysis employed by the SEC make offering clear guidance difficult, the following general observations may prove helpful to acquirors that expect to receive securities under reorganization plans.

(i) Large Creditors

Although having a large stake (10% or greater) of the relevant security does not *per se* make such holder a controlling person and, thus, an "issuer" that does not get the benefit of the section 1145(a) safe harbor, such large holders may well face greater scrutiny of their relationship with the debtor. This is particularly true if a creditor has negotiated other indicia of control under the chapter 11 plan. Parties holding 10% or more of a security of the reorganized debtor, or that have otherwise obtained board, voting or contractual rights to control the reorganized debtor, may be well-advised either to seek a no-action letter or negotiate for the right to demand shelf or piggy-back registration rights as part of the plan.[480]

Alternatively, large creditors and acquirors may be able to rely on other registration exemptions under the federal securities laws, such as Rule 144, which permits unregistered sales of restricted securities to the public after a six-month holding period, provided that there is adequate current information about the issuer on file with the SEC (among certain other requirements relating to volume limitations and manner and notice of sale). It is best to consult with experienced securities lawyers to verify that the putative seller meets the requirements for Rule 144 and that proper procedures are being followed with respect to the sale of any securities.

(ii) Directors and Officers

Directors and officers of an issuer frequently are "control persons" and, if so, are excepted from the section 1145 safe harbor discussed above. As with larger creditors, directors and officers may use the Rule 144 safe harbor. Indeed, the

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[480] *See, e.g.*, Findings of Fact, Conclusions of Law, and Order Confirming First Amended Joint Chapter 11 Plan, at 274, *In re Viatel, Inc.*, No. 01-1599 (RSB) (Bankr. D. Del. May 21, 2002), ECF No. 753 (prepackaged plan required the debtor to file registration statement on demand of holders of 25% of the authorized common stock distributed under the plan).

SEC has issued guidance that section 4(a)(1) of the Securities Act and Rule 144 both are available for control persons obtaining securities in a reorganization.[481]

(iii) Issuance of Stock by Third Parties

Issuance of stock by "an affiliate participating in a joint plan with the debtor" receives the same protection under section 1145(a) of the Bankruptcy Code as an issuance by the debtor.[482] This exception generally is understood to allow third-party plan proponents to issue securities that are covered by the exemption. However, to the extent that the securities being offered by a third party are not in "exchange for a claim against, an interest in or a claim for an administrative expense" in the debtor's or the affiliate's bankruptcy case, an investor and possibly a plan proponent should consider registering the securities. This may be the case if a plan proponent is raising fresh capital in connection with the restructuring.

(iv) Rights Offerings

As discussed in Part I.B.2.a of this outline, rights offerings are popular and effective ways of issuing securities and raising exit capital.[483] The issuance of rights and the ultimate issuance of securities underlying those rights are exempt under section 1145. Section 1145(a)(1)(B) requires that the new securities be exchanged "principally" for claims in bankruptcy, but this leaves some room for cash or property. Rights offerings—particularly those with over-subscription features—create the risk that the cash or property received will exceed the value of the claim. This is particularly true for backstopped offerings where a third party commits to buy rights in excess of claims it actually owns. For example, in *In re Penn Pacific Corp.*, the SEC challenged a disclosure statement and plan as

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[481] *See* Jacques Sardas, SEC No-Action Letter, 1993 WL 273674 (July 16, 1993); Calstar, Inc., SEC No-Action Letter, 1985 WL 54372 (Sept. 26, 1985).

[482] 11 U.S.C. § 1145(a)(1).

[483] It is critical that parties intending to participate in a rights offering pursuant to a chapter 11 plan fully understand the subscription requirements established by the plan. At least one bankruptcy court has determined that a participant was entitled to no compensation when it received less than its fair share of the securities distributed in such a rights offering as a result of mistakenly submitting erroneous information on a subscription form. *See In re Accuride Corp.*, 439 B.R. 364, 367-70 (Bankr. D. Del. 2010).

requiring registration where the claims that were being traded were considered worthless.[484]

7. Another Chapter 11 Benefit—Expedited Antitrust Review Standards

As discussed in Part III.A.7 of this outline, antitrust scrutiny of transactions effectuated through a chapter 11 plan of reorganization are granted expedited time frames and other special considerations that may improve the prospects for the transaction's approval.

8. Another Chapter 11 Benefit—Assumption, Assumption and Assignment, and Rejection of Contracts and Leases

The debtor's "executory contracts" and "unexpired leases" often are among the most valuable assets of a bankruptcy estate. Section 365(a) of the Bankruptcy Code provides a debtor with the right, subject to court approval, to "assume or reject any executory contract or unexpired lease."[485] In both the conventional plan process and the section 363 context, this ability to assume or reject executory contracts and unexpired leases creates an opportunity for a potential acquiror to reshape an acquisition target.

The Bankruptcy Code does not define the term "executory contract." In determining whether a contract is executory, courts typically consider whether "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[486] In other words, an

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[484] *See* Practising Law Institute, *Bankruptcy Developments*, 882 PLI/CORP 47, 53-54 (1995) (discussing SEC's objection in *Penn Pacific*).

[485] 11 U.S.C. § 365(a).

[486] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 MINN. L. REV. 439, 460 (1973), http://heinonline.org/HOL/P?h=hein.journals/mnlr57&i=453; *see also* 3 COLLIER ON BANKRUPTCY ¶ 365.02[2] (16th ed. 2010) (collecting authorities). The rationale underlying the so-called "Countryman" definition of "executory contract" is that a debtor with no remaining material obligations (*i.e.*, only the non-debtor has obligations) gains nothing by rejecting the contract—the debtor is the beneficiary of performance and will choose to enforce the right to performance. If the non-debtor has no remaining material obligations (*i.e.*, only the debtor has remaining obligations), then there is no point in assuming the contract—the contract is essentially a liability and the debtor will choose to reject it. A classic executory contract would be a long-term supply contract under which a debtor is required to take delivery and pay for goods in the future.

executory contract is one that has substantial performance remaining on both sides. While the term "unexpired leases" is more easily understood, courts vigilantly limit the application of section 365 to true leases, as opposed to disguised financing arrangements.[487] If a putative lease is determined not to be a true lease, then it will not be subject to assumption or rejection.

An investor should work in tandem with the debtor to identify those contracts and leases that are valuable to the business and seek their assumption. At least as important is the identification of those contracts and leases that are economically burdensome so that an acquisition target can shed their costs by moving to reject them. In addition to eliminating the ongoing expense of carrying unnecessary contracts and leases during the bankruptcy case, rejection converts damages arising from breach into prepetition claims payable in bankruptcy dollars, which may be a fraction of their face value, whereas assumption results in administrative expenses that must be paid in full.[488] In addition, claims asserted by landlords upon rejection of long-term leases are subject to a significant cap: Rejection damages are limited to the greater of one-year's rent or 15% of the remaining term of the lease in question, not to exceed three years.[489]

The Bankruptcy Code also gives a debtor a valuable right to assume and assign executory contracts and leases.[490] This allows a debtor, or its acquiror, to monetize valuable contracts and leases that are not needed for the long-term business strategy of the company. Moreover, the Bankruptcy Code generally

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[487] *See, e.g.*, *In re Lasting Impressions Landscape Contractors, Inc.*, 579 B.R. 43, 51 (Bankr. D. Md. 2017) ("The central feature of a true lease is the reservation of an economically meaningful interest to the lessor at the end of the lease term."); *In re Big Buck Brewery & Steakhouse, Inc.*, 2005 WL 1320165, at *7-8, *10-11 (E.D. Mich. May 25, 2005) (indicia of disguised financing arrangement include whether transaction (1) transfers normal risks of ownership to the lessee, (2) sets rent payments equal to debt service and (3) leaves lessor without an economic interest in the leased property upon expiration of the agreement); *see also United Airlines, Inc.* v. *HSBC Bank USA, N.A.*, 416 F.3d 609, 614-18 (7th Cir. 2005) (Easterbrook, J.) (fact that lessor has no interest in the premises at expiration of lease term indicated "lease" was disguised financing).

[488] *See* 11 U.S.C. § 365(g); *Med. Malpractice Ins. Ass'n* v. *Hirsch (In re Lavigne)*, 114 F.3d 379, 386-87 (2d Cir. 1997) (discussing section 365(g)).

[489] 11 U.S.C. § 502(b)(6).

[490] 11 U.S.C. § 365(f)(2).

overrides contractual anti-assignment provisions, thereby maximizing the ability to extract value from a debtor's portfolio of contracts and leases.[491]

a. *Conditions to Assumption or Rejection*

In order to assume an executory contract or unexpired lease, a debtor must: (1) cure, or provide adequate assurance that it will promptly cure, any pre or postpetition defaults; (2) compensate, or provide adequate assurance that it will promptly compensate, its counterparty for any actual pecuniary loss resulting from the defaults; and (3) provide adequate assurance of its ability to perform the contract or lease in the future.[492] Further, in order to assign an executory contract or unexpired lease, a debtor must first assume it and the assignee must provide adequate assurance of its ability to perform in the future.[493] The debtor must also establish that the decision to assume the contract is an appropriate exercise of its reasonable business judgment.[494]

A default relating to a debtor's *nonmonetary* obligations under an unexpired lease of real property must also be cured "by performance at and after the time of assumption in accordance with such lease."[495] Thus, for example, a debtor desiring to assume or assume and assign a commercial real estate lease with respect to which it had defaulted under a "go dark" provision should be prepared to show that the lights will be turned back on within a reasonable period of time.

In contrast to assumption, court approval of a debtor's request to reject an executory contract or unexpired lease is virtually assured, as the debtor need only

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[491] 11 U.S.C. §§ 365(f)(1), (3).

[492] 11 U.S.C. § 365(b)(1).

[493] 11 U.S.C. § 365(f)(2); *see In re Bronx-Westchester Mack Corp.*, 20 B.R. 139 (Bankr. S.D.N.Y. 1982).

[494] *See In re Vencor, Inc.*, 2003 WL 21026737, at *3 (Bankr. D. Del. Apr. 30, 2003); *see also In re Orion Pictures Corp.*, 4 F.3d 1095, 1099 (2d Cir. 1993) ("[A] bankruptcy court reviewing a trustee's or debtor-in-possession's decision to assume or reject an executory contract should examine a contract and the surrounding circumstances and apply its best 'business judgment' . . . .").

[495] 11 U.S.C. § 365(b)(1)(A); *see* 3 COLLIER ON BANKRUPTCY ¶ 365.06[3][c] (16th ed. 2010).

make the limited showing that such rejection falls within its reasonable business judgment, without the need to demonstrate the ability to cure or perform.[496]

b. *Collective Bargaining Agreements*

Collective bargaining agreements are given special treatment in the Bankruptcy Code, and the rejection of collective bargaining agreements is subject to a higher standard set forth in section 1113. A collective bargaining agreement may only be rejected if the debtor first makes a proposal to the covered employees' representative about modifications necessary to permit the reorganization and confers with the representative about the proposal.[497] If such negotiations fail, before the debtor can reject the collective bargaining agreement, the court must find that: (1) the debtor made the requisite proposal, (2) the representative refused the proposal without good cause, and (3) the balance of the equities favors rejection.[498]

In order to establish that the union representative rejected the debtor's proposal without good cause, the debtor must show that its proposed modification is necessary to its reorganization. The Third Circuit, which includes Delaware, applies a strict test, considering whether the modification is necessary for the debtor to avoid liquidation, not merely needed for its long-term financial health.[499] On the other hand, the Second Circuit, which includes New York, has a more flexible approach, which looks to what the debtor needs to attain ultimate financial health.[500] Even this looser standard is demanding, however, and New

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[496] *See In re AbitibiBowater Inc.*, 418 B.R. 815, 831-32 (Bankr. D. Del. 2009) (when debtor rejects contract, court must "examine whether a reasonable business person would make a similar decision under similar circumstances").

[497] 11 U.S.C. § 1113(b).

[498] 11 U.S.C. § 1113(c).

[499] *Wheeling-Pittsburgh Steel Corp.* v. *United Steelworkers of Am.*, 791 F.2d 1074, 1089-90 (3d Cir. 1986) ("While we do not suggest that the general long-term viability of the Company is not a goal of the debtor's reorganization, it appears from the legislators' remarks that they placed the emphasis . . . on the somewhat shorter term goal of preventing the debtor's liquidation . . . ."); *see also In re Trump Entm't Resorts, Inc.*, 810 F.3d 161, 172-75 (3d Cir. 2016) (affirming order permitting debtor to reject collective bargaining agreement where deemed necessary to avoid liquidation).

[500] *See Truck Drivers Local 807* v. *Carey Transp., Inc.*, 816 F.2d 82, 88-90 (2d Cir. 1987) (analyzing and rejecting Third Circuit's approach in *Wheeling-Pittsburgh* and holding that "the

York bankruptcy judges have closely scrutinized motions to reject collective bargaining agreements.[501]

c. *Timing of Assumption or Rejection*

Generally, executory contracts and unexpired leases may be assumed or rejected at any time until confirmation of a plan of reorganization.[502] The most significant exception to this rule is for unexpired leases of commercial real estate.

A debtor is required to assume unexpired commercial real estate leases within 120 days of the petition date.[503] If a debtor fails to assume a lease within this period, the lease is deemed rejected. A debtor may request that the bankruptcy court extend the 120-day period only once, by an additional 90 days, "for cause."[504] Any further extension requires the lessor's written consent.[505]

This time-frame requires debtors with substantial commercial leasehold interests to make decisions about those leases in the early stages of their bankruptcy cases, perhaps well before the long-term prospects for the business can be known or

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court must consider whether rejection would increase the likelihood of successful reorganization").

[501] *See, e.g.*, *In re AMR Corp.*, 477 B.R. 384, 433 (Bankr. S.D.N.Y. 2012) (denial of motion to reject collective bargaining agreement on ground that modification exceeding industry standards not shown to be necessary to successful reorganization). *See also In re AMR Corp.*, 2012 WL 3834798 (Bankr. S.D.N.Y. Sept. 5, 2012), *aff'd*, 523 B.R. 415 (S.D.N.Y. 2014) (approving later, more limited collective bargaining agreement modification). Similarly, in the *Hostess* bankruptcy, the court denied the debtor's motion to reject a collective bargaining agreement on narrow grounds. *See* Transcript of Hearing at 129, *In re Hostess Brands, Inc.*, No. 12-22052 (RDD) (Bankr. S.D.N.Y. May 14, 2012), ECF No. 1416 (debtor did not show that one percent difference in EBITDA between debtor's and union's proposals was necessary to reorganization). The Teamsters later agreed to revised modifications proposed by Hostess. *See Hostess Teamsters Vote to Accept Company's Final Offer*, Teamsters (Sept. 14, 2012), http://teamster.org/news/2013/08/hostess-teamsters-vote-accept-companys-final-offer

[502] 11 U.S.C. § 365(d)(2).

[503] 11 U.S.C. § 365(d)(4)(A)(i).

[504] 11 U.S.C. § 365(d)(4)(B)(i); *see also* Robert N. H. Christmas, *Designation Rights—A New Post-BAPCPA World*, KAM. BANKR. INST. J., Feb. 2006, at 10, 63 (discussing the 2005 amendment and noting that it was debtors' "success at obtaining essentially open-ended extensions that brought renewed Congressional scrutiny").

[505] 11 U.S.C. § 365(d)(4)(B)(ii).

assessed and before buyers have been identified whose views about assumption or rejection can be taken into account. This requirement no doubt contributed to the demise of a number of retail debtors, including A&P, Sharper Image, Linens 'N Things, Steve & Barry's, Wickes, Mervyns, Circuit City and Filene's Basement, each of which ultimately wound up in liquidation. The pressure of having to decide within 210 days whether to assume or reject long-term leases may deprive a retail debtor of the essential ability to operate through the first postpetition holiday season in order to assess which stores might be viable. Absent a landlord willing to consent to extend that period, debtors may be forced to close stores rather than risk assuming a long-term lease that will result in a large administrative expense claim if the assumption decision turns out to have been a mistake. In a weak real estate environment, landlords may be willing to grant such consents on leases that provide for rent at or near market, but likely will not consent to below-market long-term leases that many older retail chains possess. The need to act quickly on assumption/rejection decisions puts a premium on thorough preparation and analysis, as well as the ability to make quick decisions. This tight time-frame for analyzing what could be a large number of complex assets may militate in favor of a potential acquirer choosing to negotiate a stalking-horse bid with the debtor prior to the bankruptcy filing, thereby gaining the opportunity to analyze the company's commercial leases before the 210-day maximum period for assumption/rejection decisions begins to run.

d. *Ability to Override Anti-Assignment Provisions*

(i) In General

Provisions in an executory contract or unexpired lease that prohibit, restrict or condition a debtor's ability to assign are generally rendered unenforceable by section 365(f)(1) of the Bankruptcy Code. This provision overrides both express anti-assignment provisions and provisions, such as continuous operation covenants (commonly known as "go darks"), which, if enforced, could have the practical effect of precluding assignment.[506] The ability to override contractual

[506] 1 COLLIER REAL ESTATE TRANS. & BANKR. CODE ¶ 3.06[2] (2014); *see In re Haggen Holdings, LLC*, 2017 WL 3730527, at *4 (D. Del. Aug. 30, 2017) ("De facto anti-assignment provisions may be found in a variety of forms including lease provisions that limit the permitted use of the leased premises, lease provisions that require payment of some portion of the proceeds or profit realized upon assignment, and cross-default provisions." (internal quotation marks omitted)), *aff'd sub nom. Haggen Holdings, LLC* v. *Antone Corp.*, 739 F. App'x 153 (3d Cir. 2018).

anti-assignment provisions is a powerful tool in a debtor's arsenal to monetize its assets.[507]

There is an express exception to this general rule negating anti-assignment provisions in section 365(c)(1), which provides that a debtor may not assume or assign a contract without the consent of the other party if "applicable law"—*i.e.*, non-bankruptcy law—permits that party to refuse to accept performance from, or render performance to, an entity other than the debtor.[508] Thus, a debtor may not, without the consent of its counterparty, assign a contract if it is a "personal services contract," such as a contract that (justifiably) requires performance by a specific individual, certain licenses to use intellectual property, or certain regulated intangibles like FCC broadcast licenses.[509]

(ii) Shopping Center Leases

Another exception to the general rule negating anti-assignment provisions applies to leases of property in shopping centers. Restrictive covenants in a shopping center lease are excluded from the general override of anti-assignment provisions

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[507] For example, interpreting section 365(f)(1) broadly, the bankruptcy court in *In re Kmart Corp.* authorized Kmart to assign commercial real estate leases pursuant to a "designation rights agreement" despite the debtor's default under continuous operation covenants. Agreed Order Approving Designation Rights Agreement and Related Relief, at 7-10, *In re Kmart Corp.*, No. 02-02474 (Bankr. N.D. Ill. June 28, 2002), ECF No. 4797.

[508] 11 U.S.C. § 365(c)(1)(A).

[509] *See, e.g.*, *In re XMH Corp.*, 647 F.3d 690, 695 (7th Cir. 2011) (trademark licenses are not assignable in the absence of a clause expressly authorizing assignment); *Miller* v. *Glenn Miller Prods., Inc.*, 454 F.3d 975, 988, 992-93 (9th Cir. 2006) (same); *Everex Sys., Inc.* v. *Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679-80 (9th Cir. 1996) (federal common law, and therefore section 365(c)(1), prohibits assignment of nonexclusive patent licenses absent counterparty consent); *In re Headquarters Dodge, Inc.*, 13 F.3d 674, 682-83 (3d Cir. 1993) (state law, and therefore section 365(c)(1), prohibits assignment in bankruptcy of "personal service contracts"); *In re Tak Commc'ns, Inc.*, 138 B.R. 568 (W.D. Wis. 1992) (noting that FCC broadcast licenses are not assignable under the Communications Act), *aff'd*, 985 F.2d 916 (7th Cir. 1993); *In re Patient Educ. Media, Inc.*, 210 B.R. 237, 240-43 (Bankr. S.D.N.Y. 1997) (federal common law, and therefore section 365(c)(1), prohibits assignment of nonexclusive copyright licenses absent counterparty consent). It is a subject of some dispute whether an exclusive license to intellectual property is assignable without counterparty consent. *Compare Gardner* v. *Nike, Inc.*, 279 F.3d 774, 777-81 (9th Cir. 2002) (federal law bars assignment of exclusive copyright licenses absent counterparty consent), *with In re Golden Books Family Entm't, Inc.*, 269 B.R. 311, 314-19 (Bankr. D. Del. 2001) (federal law permits assignment of exclusive copyright licenses regardless of counterparty consent).

by section 365(b)(3), which provides that adequate assurance of future performance under a shopping center lease includes, *inter alia*, adequate assurance of compliance with all of the lease provisions restricting "radius, location, use, or exclusivity"[510] and "tenant mix or balance."[511] If assumption or assignment would violate any such provision in a shopping center lease, neither the debtor nor the assignee of the lease can provide adequate assurance of future performance, and assumption and assignment will not be permitted. The effect of this carveout is to require that all restrictive covenants in a shopping center lease be complied with by an assignee of the debtor.[512]

While the Bankruptcy Code does not define the term "shopping center," the Third Circuit has articulated a multifactor test that courts regularly use to determine whether leased premises are in a shopping center.[513] The most important factors to be considered are likely to be whether there is "a combination of leases held by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area."[514]

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[510] 11 U.S.C. § 365(b)(3)(C).

[511] 11 U.S.C. § 365(b)(3)(D).

[512] *In re Three A's Holdings, L.L.C.*, 364 B.R. 550, 557, 560-61 (Bankr. D. Del. 2007) (debtor could not assume and assign its shopping center lease where the assignee proposed to use property as pharmacy rather than as a purveyor of "health supplies," an incurable default under a restrictive use covenant).

[513] *See In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1087-88 (3d Cir. 1990). The full list of *Joshua Slocum* factors includes whether: (i) there is a combination of leases; (ii) all leases are held by a single landlord; (iii) all tenants are engaged in commercial retail distribution of goods; (iv) a common parking area is present; (v) the premises was purposefully developed as a shopping center; (vi) a master lease exists; (vii) there are fixed hours during which all stores are open; (viii) joint advertising exists; (ix) the tenants are contractually interdependent as evidenced by restrictive use covenants; (x) there are percentage rent provisions in the tenants' leases; (xi) the tenants have the right to terminate their leases if the anchor tenant terminates its lease; (xii) the tenants share responsibility for trash removal and maintenance; (xiii) a tenant mix exists; and (xiv) the stores are contiguous. Not all of these factors need to be present for the court to conclude that a property constitutes a shopping center. *See id.*

[514] *In re Ames Dep't Stores, Inc.*, 348 B.R. 91, 95 (Bankr. S.D.N.Y. 2006) (citation and internal quotation marks omitted).

9. Another Chapter 11 Benefit—Tax-Free Reorganizations

In certain circumstances, a restructuring of an insolvent or bankrupt company may qualify as a tax-free reorganization for federal income tax purposes. Specifically, the Internal Revenue Code permits a company under a "title 11 or similar case"[515] to transfer assets in a tax-free reorganization (known as a "G" reorganization) where the acquiror issues stock or securities as consideration,[516] but other types of reorganizations may be available to troubled companies. There are many requirements for a transaction to qualify as a reorganization for tax purposes and such requirements vary depending on the type of reorganization transaction. While a full discussion of the reorganization rules is beyond the scope of this outline, certain of those rules specific to creditors are highlighted below.

Generally, for a transaction to qualify as a tax-free reorganization (including a G reorganization), the shareholders of the target company must maintain "continuity of interest."[517] This means that a substantial part of the consideration received by the target shareholders must consist of stock of the surviving entity.[518] In certain circumstances, creditors of the target company that receive stock in the reorganization count toward satisfaction of this requirement (essentially being treated as the shareholders of the debtor).[519] Notably, these rules extend beyond G reorganizations to reorganizations of insolvent companies outside of bankruptcy.[520]

The regulations set forth detailed rules for valuing the claims of creditors as proprietary interests based on the seniority of the claim. The value of a claim of the most senior class of creditors is determined by a formula based on the value of the interests and other consideration received in exchange for the claim, while the

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[515] "Title 11 or similar case" means a case under title 11 of the U.S. Code or a receivership, foreclosure or similar proceeding in a federal or state court.

[516] *See* 26 U.S.C. § 368(a)(1)(G).

[517] Note that, for reorganizations that are recapitalizations or mere changes of identity or form for tax purposes, the continuity of interest requirement does not apply. 26 C.F.R. § 1.368-1(b).

[518] *See generally* 26 C.F.R. § 1.368-1(e).

[519] *See* 26 C.F.R. § 1.368-1(e)(6).

[520] *See id.*

value of a claim of a junior class of creditors is the fair market value of the claim.[521]

Where reorganization treatment is desired, these rules may be of particular importance because they expand the circumstances in which creditors can participate in a tax-free reorganization (such as a situation where a company formed by creditors acquires substantially all of the assets of an insolvent company outside of bankruptcy). However, where a distressed company or its creditors wish to avoid a tax-free reorganization (for example, where the creditors want to recognize a loss on the exchange or where the company wants to recognize gain on the exchange of its assets to achieve a step-up in tax basis), such avoidance may prove more difficult.

Even though, as a general rule, creditors may satisfy the continuity of interest requirement, as noted above, there are many other requirements for a transaction to qualify as a tax-free reorganization. Notably, a creditor claim must be a "security" for tax purposes for the exchange to be tax free.[522] Because debt with a term of less than five years generally is not considered a "security," this requirement could present an issue, for example, if the claim represents trade debt or other short-term debt.

Even if a claim is a security and all the requirements for a reorganization are met, a creditor will be required to recognize gain (but not loss) if it receives other property (*i.e.*, property other than stock or securities of the reorganized entity) in exchange for its claims.[523] Also, a portion of the consideration received by the creditors (even if solely stock or securities) may be treated as accrued and unpaid interest, and will be taxable as such.[524]

In addition, a tax-free reorganization may still trigger an "ownership change" that could limit a debtor's ability to use existing NOLs (and certain "built-in losses") of the reorganized company to offset future taxable income. This issue is discussed further in Part IV.D.1.e.i of this outline.

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[521] *See* 26 C.F.R § 1.368-1(e)(6)(ii).

[522] *See* 26 U.S.C. § 354(a). *See also* Part I.B.4.c.viii.

[523] *See* 26 U.S.C. § 356.

[524] *See* 26 U.S.C. § 354(a)(2)(B); *see also* 26 C.F.R. § 1.446-2.

Finally, even in an otherwise tax-free reorganization, a debtor may be required to recognize COD income to the extent that it is relieved of the obligation to repay its outstanding debt.[525] Where a debtor issues stock in satisfaction of its debt, it is treated as paying an amount of money equal to the fair market value of the stock so issued; thus, the debtor will recognize COD income to the extent that the fair market value of the stock is less than the amount of debt exchanged therefor.[526] If a company is a debtor in a chapter 11 case, or is insolvent,[527] its COD income is excluded from its income and thus is not taxable.[528] However, the amount excluded from income reduces the amount of certain tax attributes of the corporation, including NOLs and tax basis in property held by the company.[529]

While some of these issues do not directly affect the taxation of a creditor participating in a reorganization, the potential impact on a rehabilitated debtor's cash flow is likely to impact the negotiation of a plan of reorganization.

10. Issues Regarding Restructuring Support Agreements

a. *Restrictions on Solicitation of Votes Through Postpetition Restructuring Support Agreements*

A restructuring support agreement, also known as a plan support agreement or "lock-up" agreement, is an agreement by a creditor to cast its vote either in favor of or against a plan of reorganization. It is essentially a device designed to assure in advance the successful confirmation of a plan based upon its agreed treatment of particular creditors or creditor groups. Various legal controversies have arisen over the years with respect to the enforceability and propriety of restructuring support agreements.

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[525] See 26 U.S.C. § 61(a)(12), also discussed in Part I.A.2.c and Part I.B.4.c.viii of this outline (where a new election to defer COD income is addressed).

[526] *See* 26 U.S.C. § 108(e)(8).

[527] For this purpose, "insolvent" means the excess of liabilities over the fair market value of the company's assets, measured as of immediately before the debt discharge. *See* 26 U.S.C. § 108(d)(3). It should be noted that in the case of a debtor that is entitled to exclude COD income because it is insolvent, such rules (and corresponding attribute reduction) apply only to the extent that the debtor is insolvent. *See* 26 U.S.C. § 108(a)(3). If there is COD income in excess of the amount by which the debtor is insolvent, the excess COD income is not excluded.

[528] See 26 U.S.C. § 108(a), also discussed in Parts I.A.2.c and I.B.4.c.viii of this outline.

[529] *See id.*

The cause of these controversies is section 1125(b) of the Bankruptcy Code, which generally prohibits the solicitation of votes to accept or reject a plan until there has been a disclosure statement approved as containing adequate information to allow creditors to cast an informed vote.[530] Arguably, a restructuring support agreement is an agreement by a creditor to vote either in favor of or against a plan that is entered into at a time when there is no court-approved disclosure statement, in violation of section 1125(b).[531] Prepackaged plans of reorganization have a statutory exception to this rule that permits votes to be solicited without a disclosure statement, pursuant to section 1126(b), if they are cast *before* the bankruptcy filing. While votes cast *after* the filing are not similarly authorized by section 1126(b), postpetition solicitation of votes is permitted pursuant to section 1125(g) so long as the solicitation of the claim holder commenced prior to the bankruptcy filing and was in compliance with any applicable law (presumably the federal securities laws).[532]

The effect of section 1125(g) is to protect pre-negotiated bankruptcies in the event that a bankruptcy petition is filed before a restructuring support agreement is signed. Without this safe-harbor provision, parties that were moving toward a consensual plan but had not yet finalized an agreement would be at risk of having their negotiations derailed by a bankruptcy filing.[533]

Section 1125(g) does not, on its face, protect a restructuring support agreement if it is negotiated entirely postpetition. Nonetheless, a handful of bankruptcy court decisions have held that even a restructuring support agreement that is negotiated entirely postpetition without an approved disclosure statement will not constitute an impermissible solicitation under section 1125(b).

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[530] *See* 11 U.S.C. § 1125(b).

[531] *See generally* Josef S. Athanas & Caroline A. Reckler, *Lock-Up Agreements—Valuable Tool or Violation of the Bankruptcy Code?*, 15 J. BANKR. L. & PRAC. 4, at Art. 4, Part II (2006).

[532] *See, e.g.*, *In re CIT Grp. Inc.*, 2009 WL 4824498, at *3-4 (Bankr. S.D.N.Y. Dec. 8, 2009).

[533] Kurt A. Mayr, *Unlocking the Lockup: The Revival of Plan Support Agreements Under New § 1125(g) of the Bankruptcy Code*, 15 J. BANKR. L. & PRAC. 729, 733 (2006) ("[A]bsent § 1125(g), a debtor in the midst of finalizing a pre-negotiated bankruptcy filing would risk forgoing the benefit of that process if it became necessary for the debtor to file for bankruptcy before it was able to gather all necessary plan support agreement signatures because of the potential that any postpetition plan support agreement activity could be deemed a 'solicitation.'").

In *In re Indianapolis Downs, LLC,*[534] the Bankruptcy Court for the District of Delaware took a pragmatic approach to this issue and denied a motion to disqualify votes that were committed pursuant to a postpetition restructuring support agreement that was signed and filed with the court on the same day that the debtor filed a disclosure statement.[535] Given the timing and the fact that the creditors' "commitment to vote was limited to a plan conforming to the [agreement], after Court approval of an appropriate and conforming disclosure statement," the court held that the solicitation should be "deemed to have taken place after the Court approved the amended disclosure statement."[536] In any case, the court noted, "[w]hen a deal is negotiated in good faith between a debtor and sophisticated parties, and that arrangement is memorialized [in] a written commitment and promptly disclosed," automatic designation [*i.e.*, disqualification of votes] is not required.[537]

In *In re Residential Capital, LLC*, the Bankruptcy Court for the Southern District of New York approved a postpetition restructuring support agreement that obligated parties to vote in favor of the plan, but which contained "numerous termination events that allow[ed] a party to withdraw from [the] obligation under certain circumstances."[538] The court noted that the parties had not agreed to vote in favor of the plan "unless and until the Court approve[d] a disclosure statement and their votes ha[d] been properly solicited pursuant to section 1125."[539]

As a practical matter, postpetition negotiation of restructuring support agreements occurs regularly. Although the risk of such an agreement being held to violate section 1125(b) has certainly been reduced in the wake of these cases—at least in New York and Delaware—debtors and creditors should still proceed cautiously in assessing whether a restructuring support agreement they reach will be problematic. For instance, protective devices, such as a "fiduciary out," which allows a party to the restructuring support agreement to support a different

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[534] 486 B.R. 286 (Bankr. D. Del. 2013).

[535] Section 1126(e) of the Bankruptcy Code provides that a potential consequence of improperly soliciting votes is for those votes to be disqualified. *See* 11 U.S.C. § 1126(e).

[536] *Id*. at 297 (quoting *In re Kellogg Square P'ship*, 160 B.R. 336 (Bankr. D. Minn. 1993)).

[537] *Id.*

[538] 2013 WL 3286198, at *20 (Bankr. S.D.N.Y. June 27, 2013).

[539] *Id.* at *5.

agreement if necessary to fulfill its fiduciary duty, may convince a court to reject a challenge to the agreement on the basis of section 1125(b) so long as it appears to serve a legitimate purpose and to have reasonable terms.

b. *Prepetition Restructuring Support Agreements: Ineligibility to Sit on a Creditors' Committee*

Entry into a prepetition restructuring support agreement may also have the unintended consequence of depriving a creditor of the ability to serve on an official creditors' committee. In 2002, the Office of the U.S. Trustee for the Third Circuit (which includes Delaware) adopted the position that any creditor that executes a prepetition restructuring support agreement is ineligible to serve on a creditors' committee.[540] This position appears to have been motivated by a concern that the use of pre-negotiated chapter 11 plans and restructuring support agreements harms small creditors and official committees by depriving them of a meaningful role in the chapter 11 plan formulation process: If major creditors negotiate restructuring support agreements prepetition, then, by the time a creditors' committee can be appointed, the plan is effectively a *fait accompli*.

Creditors wishing to preserve their ability to serve on an official committee in any jurisdiction should consider including "fiduciary out" provisions in restructuring support agreements. There is no guarantee, however, that the inclusion of a "fiduciary out" provision will prevent the U.S. Trustee from opposing such a creditor's bid to serve on an official committee. Creditors should be mindful of the risk, and potential purchasers and plan sponsors should recognize that compelling friendly unsecured creditors to enter into restructuring support agreements prepetition could result in control of the creditors' committee being turned over to potentially less friendly creditors.

c. *Prepetition Restructuring Support Agreements: Difficulty of Assumption*

Entry into a prepetition restructuring support agreement will generally provide tangible benefits to a debtor by locking in creditor support that can streamline the plan process when a chapter 11 case is commenced. From the perspective of creditors, however, the benefits are less certain. The agreement is unlikely to be enforceable against the debtor, who can reject any prepetition agreements. The

[540] *See* Roberta A. DeAngelis & Nan Roberts Eitel, *Committee Formation and Reformation: Considerations and Best Practices*, AM. BANKR. INST. J., Oct. 2011, at 20, 58 (citing lock-ups and intercreditor agreements as conflicts that disqualify creditors from serving on a committee).

asymmetry that results from the agreement likely being binding on creditors but not the debtor can frustrate negotiations. While a restructuring support agreement may have the intangible benefit to creditors of establishing management's support for, and creating momentum toward the completion of, the negotiated restructuring, the agreement will be exceedingly difficult for the creditor to enforce unless it is assumed by the debtor.[541] And assumption of a restructuring support agreement, even if sought by a debtor, will not always be granted by a bankruptcy court. For example, in *In re Innkeepers USA Trust*, the bankruptcy court declined to permit a debtor to assume a restructuring support agreement.[542] Moreover, even seeking assumption of a restructuring support agreement can have a significant downside. It may precipitate litigation over the merits of the proposed plan, addressing many of the same issues that will arise at the confirmation hearing, at a time when consideration of those issues is arguably premature.

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[541] Assumption of a restructuring support agreement may have the additional tangible benefit of allowing payment of a creditor's fees and expenses, which is often provided for in restructuring support agreements, to take place during the bankruptcy case.

[542] 442 B.R. 227 (Bankr. S.D.N.Y. 2010). *Innkeepers* presented particularly problematic circumstances. The bankruptcy court found that entry into the agreement, which purported to bind the debtor to propose a plan favoring certain of its secured creditors over others, was not a disinterested business transaction, as the debtor's controlling shareholder stood to gain from the transaction. *See id.* at 231. Moreover, in light of the debtor's truncated marketing process and minimal diligence, the substantial possibility that consenting creditors would not be obligated to support the proposed plan, and the limited fiduciary out retained by the debtor, the bankruptcy court determined that the debtor had exercised neither due care nor good faith in entering into the lock-up agreement and that the debtor would not benefit from its assumption. *See id.* at 232-35.

IV.

Acquisition and Trading in Claims of Distressed Companies

Purchase of a distressed company's debt can create a number of opportunities for a potential purchaser. It can open the door to an information advantage over other potential buyers and a profit opportunity if the acquisition is not consummated but the debt appreciates in value. Owning claims pre-bankruptcy can provide leverage to influence a company to sell assets, raise equity or offer to exchange debt for equity. Owning claims can also provide an inside track if an issuer decides to enter a prepackaged or pre-negotiated bankruptcy. Additionally, an existing debtholder has advantages in the bankruptcy process, including the right to be heard in court, as well as, for a secured creditor, the ability to credit bid in an auction. The purchase of sufficient amounts of debt also gives a holder the ability to influence the outcome of the vote on confirmation of a bankruptcy plan. Part IV of this outline highlights issues for an investor to consider with respect to purchasing claims both pre- and post-bankruptcy filing. In addition to bankruptcy law considerations, trading debt claims also requires consideration of the tax, securities laws and HSR Act implications discussed below.

A. What Claims Should an Investor Seeking Control Buy?

1. Procedural Considerations

There is no provision of the Bankruptcy Code that explicitly regulates claims trading.[543] Nonetheless, trading in claims against debtors is clearly contemplated, as Bankruptcy Rule 3001(e) requires filing with the court clerk proof of any transfer of a claim for which a proof of claim has already been filed, and provides that when a claim is transferred outright before a proof of claim has been filed, only the transferee may file a proof of claim and may need supporting documentation from the transferor to do so.

Trading in claims may occur in organized markets or *ad hoc* and may involve various forms of debt. Purchasers of bond debt and bank debt usually have the advantage of knowing with relative certainty the amount of the purchased claim that will be allowed. In contrast, purchasers of other types of claims, such as

[543] *See In re UAL Corp.*, 635 F.3d 312, 324 (7th Cir. 2011) (as amended on denial of reh'g) ("Claims trading remains a gray area in bankruptcy law that the courts and Congress have left to the parties to negotiate.").

trade debt on account of goods and services provided to the debtor, landlord claims arising from lease rejection, derivatives closeout claims, and litigation claims, may face greater uncertainty as to how much, if any, of the claim will be allowed, as such claims may be subject to significant dispute.[544] A holder of a claim to which an objection has been made may file a motion requesting that the claim be temporarily allowed by the bankruptcy court for the purpose of voting on a plan of reorganization,[545] but there is no assurance that the motion will be granted or that the full amount of the asserted claim will be temporarily allowed. An investor therefore may find that a purchased claim entitles it to less voting power, or a smaller recovery, than it anticipated at the time of the purchase.

2. The Claim Purchaser Should Identify and Acquire the "Fulcrum" Security

An investor seeking to acquire a controlling stake in a reorganized debtor generally will want to accumulate the so-called "fulcrum" security—*i.e.*, the most junior class of claims or interests that is not entirely "out of the money" and is therefore entitled to the debtor's residual value. When a debtor has adequate collateral to refinance or reinstate all of its secured debt, the fulcrum security is likely to be the unsecured debt. In contrast, when a debtor can reinstate or repay its first-lien lenders, but not lenders with junior liens, the company's second- or even third-lien debt will be the fulcrum security. And in situations where a debtor is solvent, prepetition equity interests are the fulcrum security. Regardless of which security is ultimately at the fulcrum, its holders are in a position to control a debtor if that security is converted into a significant portion of the new equity.

There are also several reasons why it may be beneficial for an investor to accumulate claims or interests other than just the fulcrum security. For example, subject to the cramdown rules (discussed in Part III.B.2.f above)—which may obviate the need for an affirmative vote by a class—the ability to ensure confirmation (or rejection) of a plan depends on the tally of votes of various classes. Thus, to influence the process, it can be beneficial to hold large positions in other classes in addition to the one that holds the fulcrum security.

Further, often there is uncertainty and controversy over which class is at the fulcrum, in addition to the possibility that the location of the fulcrum may change

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[544] *See* Adam Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 86-89 (2009).

[545] Fed. R. Bankr. P. 3018(a).

over time if the actual or perceived value of a debtor shifts before or during the chapter 11 case. For example, for most of the nearly three years of the *LightSquared* case, most of the parties in interest (other than Harbinger) believed that Harbinger's equity was out of the money, and that the fulcrum security was the first lien debt. Approximately $1 billion of the first lien debt was purchased in the secondary market by a special purpose entity affiliated with Charles Ergen, chairman and CEO of DISH Networks Corp., a competitor of LightSquared. Some 17 months into the case, the bankruptcy court approved a stalking-horse bid from DISH to acquire the company at a price that would pay the first lien debt in full but leave nothing for equity, overruling Harbinger's objection that the bid would not maximize the value of LightSquared's spectrum assets. In January 2014, however, Ergen and DISH exercised a right to terminate the bid, and Ergen thereafter found himself the target of litigation aimed at equitably subordinating his claims and cramming down a plan of reorganization that would give him third lien notes payable in seven years for his first lien debt. While there can be little doubt that Ergen had purchased the first lien debt on the assumption that it was the fulcrum security, an auction of unrelated spectrum that occurred two and a half years into the case raised expectations about the value of the spectrum, and precipitated a bidding war. In the end, the substantial delay in concluding the case afforded the opportunity for the equity to wind up in the money, which had not been anticipated when the case was filed. Ergen, who had made a billion dollar investment in LightSquared debt, no doubt in pursuit of a loan to own strategy, wound up being cashed out. The LightSquared saga thus highlights an important difference between the typical M&A transaction and one pursued through the purchase of claims in bankruptcy: Unlike a prospective acquiror in an M&A deal who can simply walk away if the deal becomes unattractive for any reason, once a potential acquiror has made an investment in distressed debt, there may be little choice but to ride out the process until the end.

Of course, many variables can affect the ultimate valuation at the end of a case, from a failure to achieve projected post-filing operating results to deteriorating capital markets and industry conditions. In light of this inherent uncertainty, a purchaser that buys only claims or interests in a junior class that could prove to be "out of the money" runs the risk of having a plan confirmed through a cramdown based on a low-end valuation of the debtor, leaving the purchaser with little or no recovery. In contrast, a purchaser seeking to control a reorganized entity that buys only claims in a class of senior debt that ultimately could be reinstated runs the risk of holding debt in the reorganized debtor rather than new equity. It is also possible that a class of claims senior to the fulcrum security may consensually choose to take equity in the reorganized debtor notwithstanding its entitlement to a distribution in a higher form of currency.

Buying a controlling share of claims at the fulcrum can require a significant investment, particularly at the general unsecured level, given that unsecured financial debt and significant trade, lease rejection and contract claims may be classified together. The proponent of a plan of reorganization can manipulate classification within the limits of section 1122 of the Bankruptcy Code: it can dilute an entity's control of a class by enlarging the class to include additional claims of a like legal nature; it can also reduce the size of a class by splitting out likely dissidents into a class of their own and then cramming down on that class, as discussed in Part III.B.2.f. It is permissible to place similar claims in different classes if the plan proponent "can show a business or economic justification for doing so," but a court will not approve a plan "placing similar claims differently solely to gerrymander an affirmative vote on the reorganization plan."[546] The ultimate size of the general unsecured class may be difficult to predict with any certainty, as it will be affected by contract rejection, liquidation of contingent or unliquidated claims, and the materialization of other previously unknown claims such as environmental and tort liabilities.

3. Strategic Considerations in Accumulating a Blocking or Controlling Position

Buying a control position in a class of claims can be trickier than it appears. Generally, confirmation of a plan of reorganization requires the affirmative vote of at least two-thirds in amount plus a majority in number of those claims voting in each class of claims entitled to vote.[547] Thus, although a purchaser can *block* the acceptance of a plan by a class by acquiring more than one-third in amount of the claims in that class, to acquire a control position, *i.e.*, one that is sufficient to ensure that the class *approves* a plan, a purchaser must acquire two-thirds in amount and a majority in number of the relevant claims. As a result, if, for example, a purchaser were to acquire $99 million of a separately classified $100 million note issue, and a holdout, refusing to sell its $1 million of the issue, was the only other creditor in the class, the holdout may be able to block plan acceptance by the class despite the purchaser's overwhelming dominance in amount—but not number—of claims.[548]

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[546] *In re Loop 76, LLC*, 465 B.R. 525, 537 (B.A.P. 9th Cir. 2012), *aff'd*, 578 F. App'x 644 (9th Cir. 2014).

[547] *See* 11 U.S.C. § 1126(c).

[548] In the relatively rare case of a debtor with meaningful value for equity interests, control of a class of interests is simpler. Acceptance of a plan by a class of equity interests, such as a class of

The majority-in-number ("numerosity") requirement of section 1126(c) does not mesh well with the significant increase in the trading of claims that has occurred in recent years.[549] Application of the numerosity requirement to traded claims raises some difficult questions, including whether claims originally held by separate parties continue to count as separate claims when they are consolidated into the hands of one party and, conversely, whether a claim originally held by a single party will be counted as multiple claims once it is split into pieces and sold.

The law is relatively clear that—for purposes of the numerosity test—holders of multiple purchased *trade* claims are entitled to as many votes as they have acquired claims.[550] Courts analyzing the voting of purchased trade claims have reasoned that each such claim arises out of a separate transaction with the debtor and, thus, constitutes a separate right to payment against the debtor. Using the same logic, a single trade claim arguably *cannot* be split among various buyers for voting purposes. Indeed, in *In re Figter Ltd.*, en route to holding that a purchaser of multiple claims is entitled to vote each claim separately, the Ninth Circuit cautioned: "Of course, that is not to say that a creditor can get away with splitting one claim into many, but that is not what happened here."[551] The Ninth Circuit further explained that "[v]otes of acceptance . . . are to be computed only on the basis of filed and allowed proofs of claim," regardless of whether those claims are later split.[552] Thus, just as the Ninth Circuit did not allow votes pertaining to separately filed proofs of claim to be collapsed, it appears that it might not allow multiple votes to be cast on account of a claim that was evidenced by a single

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preferred stock, is tallied solely by reference to the vote of two-thirds in "amount" of the interests. 11 U.S.C. § 1126(d).

[549] In cases such as *Lehman Brothers* and *MF Global*, the volume of claims traded was extremely high. Claims trading market operator SecondMarket recorded 867 Lehman Brothers and MF Global trades with a total value of $3.79 billion in October 2012 alone. Jacqueline Palank, *Lehman, MF Global Dominate October Claims Trading*, WALL ST. J. (Nov. 29, 2012), http://on.wsj.com/UedOlV. SecondMarket has since shut down its bankruptcy claims trading platform. Rachel Feintzeig, *SecondMarket Shuts Down Bankruptcy Claims Platform*, WALL ST. J. PRO BANKR. (Mar. 19, 2013), https://www.wsj.com/articles/DJFDBR0020130318e93iln7q3.

[550] *See, e.g.*, *In re Figter Ltd.*, 118 F.3d 635 (9th Cir. 1997); *In re Concord Square Apartments of Wood Cty., Ltd.*, 174 B.R. 71 (Bankr. S.D. Ohio 1994); *In re Gilbert*, 104 B.R. 206 (Bankr. W.D. Mo. 1989).

[551] 118 F.3d at 641.

[552] *Id.* at 640 (quoting *In re Gilbert*, 104 B.R. at 211).

proof of claim if the claim was later sold to multiple buyers.[553] It is unclear which of those multiple buyers (if any) would retain the right to vote the single claim.

In contrast, claims based on notes or bonds from the same issue generally are not counted separately once they are concentrated in the hands of one creditor.[554] Thus, for example, even bondholders that have accumulated positions from multiple sellers at varying prices are likely to receive only a single vote for numerosity purposes. Although few cases have squarely addressed the issue, the apparent rationale for treating bond or note claims differently from trade claims is that, unlike trade claims, claims arising out of a single financing transaction do not arise out of separate contractual relationships and transactions.

An acquiror can seek to maximize its influence over the voting process by paying attention to the Bankruptcy Code's numerosity requirement. When buying trade claims, an acquiror can seek to buy a large number of small claims rather than a small number of large claims. It should be noted, however, that purchasing multiple trade claims can bring a significant practical burden: Each claim requires individual scrutiny to ensure that the claim is not burdened with potential objections to its validity or amount.

Moreover, at least in certain circumstances, an acquiror of financial debt can monitor who else owns the debt; if the debt is dispersed, a purchaser can buy from multiple parties, thereby reducing the total number of holders and thus decreasing the risk that a favored plan will be voted down based on the numerosity requirement.[555] Finally, a buyer of financial debt might purchase claims through multiple entities, understanding that there is some risk that a court ultimately might deem the claims to be held by one entity due to their common control.

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[553] *Cf. In re Meridian Sunrise Vill., LLC*, 2014 WL 909219, at *5 (W.D. Wash. Mar. 7, 2014) (stating, with respect to claims under loan agreement, that "[a] creditor does not have the right to split up a claim in such a way that artificially creates voting rights that the original assignor never had" because otherwise "any voter could veto the Plan by assigning its claims to enough assignees").

[554] *See In re Bd. of Dirs. of Multicanal S.A.*, 314 B.R. 486, 515 (Bankr. S.D.N.Y. 2004) (suggesting, *in dicta*, that holders rather than holdings are counted to determine numerosity in the case of notes and bonds); *In re Glob. Ocean Carriers Ltd.*, 251 B.R. 31, 36 (Bankr. D. Del. 2000) (numerosity requirement led to rejection of reorganization plan where 321 of 497 noteholders, though representing less than $6 million of approximately $104 million of voting notes, voted to reject plan).

[555] As a general matter, the plan proponent will establish a record date for determining the ownership of claims, at which time the numerosity requirement is determined.

B. Acquisition of Claims and Participation in the Bankruptcy Case

1. Section 1109(b)

An investor that wishes to participate in a company's chapter 11 case generally needs to qualify as "a party in interest" under section 1109(b) of the Bankruptcy Code. That section grants a party in interest the right to "raise and . . . be heard on any issue."[556] While section 1109(b) specifically defines certain parties as "parties in interest" (including the debtor, the creditors' committee, the equity committee, any creditor, any equity security holder or an indenture trustee), the provision is not intended to be exhaustive.[557] There is a question, however, whether investors who do not fit into any of these categories, including prospective acquirors, holders of participation interests and total return swaps, as well as other investors who for various reasons may not hold a direct claim against the debtor, may actively participate in a company's bankruptcy case.

a. *Prospective Acquirors*

Despite the broad definition of "party in interest," the U.S. Court of Appeals for the Third Circuit and certain other courts have ruled that a prospective acquiror of the debtor is not necessarily a "party in interest" with standing to be heard in a chapter 11 case, even if the acquiror has signed a purchase agreement.[558]

Nevertheless, some bankruptcy courts have allowed prospective acquirors to object to bid procedures and break-up fees. For example, in both the *Lehman Brothers* bankruptcy (in connection with the auction of Neuberger Berman) and

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[556] 11 U.S.C. § 1109(b).

[557] *See, e.g.*, *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 214 n.21 (3d Cir. 2004) (noting that statutory list of "parties in interest" is not exhaustive); *In re Co Petro Mktg. Grp., Inc.*, 680 F.2d 566, 572-73 & n.12 (9th Cir. 1982) (holding that a regulatory agency with supervisory responsibility over the debtor was a "party in interest," but stating that the agency, though a party in interest, was only one for the purpose of intervening to move to dismiss an improperly filed chapter 11 petition); *In re First Humanics Corp.*, 124 B.R. 87, 90 (Bankr. W.D. Mo. 1991) (claims purchaser who did not technically comply with rules governing claims purchases had standing as party in interest and creditor to propose a reorganization plan).

[558] *See In re O'Brien Envtl. Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999) (prospective acquiror lacked standing to object to bankruptcy court order denying approval of a proposed purchase agreement between prospective acquiror and the debtor); *accord In re Rook Broad. of Idaho, Inc.*, 154 B.R. 970, 974 (Bankr. D. Idaho 1993); *In re Crescent Mfg. Co.*, 122 B.R. 979, 981 (Bankr. N.D. Ohio 1990).

the *Refco* bankruptcy (in connection with the auction of Refco's broker-dealer), the Bankruptcy Court for the Southern District of New York entertained and considered formal written objections to proposed auction rules by prospective acquirors. Likewise, in the *Linens 'N Things* bankruptcy in the District of Delaware, competing bidders were allowed to be heard on objections to the terms of a stalking-horse bid. Although none of these bankruptcy courts ruled on the prospective acquirors' standing, by considering the prospective acquirors' objections, the courts appear to have adopted a pragmatic, expansive view of section 1109(b)'s requirement that only a "party in interest" has the right to be heard. Further, at least one court has explicitly held that even if a potential bidder lacks standing, its voice still should be heard. "As parties with interest, prospective bidders may be positioned to offer valuable insight and perspective. Though arguably not parties in interest, they are welcomed to appear at least as friends of the court."[559]

Aside from appearing in court directly, there are several other ways for a prospective acquiror to communicate its position on matters that relate to a potential sale. First, a prospective acquiror can share any concerns about a proposed sale process with the creditors' committee, other official or unofficial committees, or the U.S. Trustee. Given the role of the creditors' committee as a fiduciary for all unsecured creditors, the bankruptcy court will likely give more weight to a prospective acquiror's views if they are voiced by the committee.

Alternatively, if a prospective acquiror wishes to be heard in court without facing technical challenges to its standing, that acquiror may be able to purchase a nominal amount of claims to become a creditor of the debtor, as that status is sufficient to confer standing. A number of cases have held that under the broad language of section 1109(b), a creditor is no less a "party in interest" simply because it acquired its claims postpetition, even if the creditor's sole purpose in acquiring claims was to ensure standing.[560] However, an acquiror considering this tactic should be careful to acquire a direct claim against the debtor, since a

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[559] *In re Jon J. Peterson, Inc.*, 411 B.R. 131, 135 (Bankr. W.D.N.Y. 2009).

[560] *See In re Family Christian, LLC*, 533 B.R. 600, 621 (Bankr. W.D. Mich. 2015) (holding that a potential acquiror had standing by virtue of its purchase of an administrative expense); *In re Embrace Sys. Corp.*, 178 B.R. 112, 120-21 (Bankr. W.D. Mich. 1995) (noting that "mere status as an interested purchaser does not negate [potential purchaser's] rights as a creditor"); *In re First Humanics Corp.*, 124 B.R. 87, 91 (Bankr. W.D. Mo. 1991) (holding that since the Code expressly specifies that a creditor is a "party in interest," when claims were purchased is "of no consequence").

"creditor of a creditor"—such as the holder of a participation in a claim—does not automatically have standing.

A prospective acquiror who becomes a creditor must also make sure that it deals with any issues arising from possession of nonpublic information, that it has not signed a standstill or similar agreement that may prohibit such a purchase and that there is no other impediment to buying such claims. The prospective acquiror should make clear in any court filing that, in addition to its status as a creditor, it is an actual or potential bidder for the debtor or the debtor's assets.

b. *Parties to Participation Agreements and Total Return Swaps*

It is generally better for a potential acquiror to purchase claims against a debtor by assignment or sale, rather than through a participation agreement or synthetically through a total return swap, because the purchaser or assignee of a claim obtains a direct claim against the debtor.

However, a purchase or assignment is not always possible, particularly in the case of bank debt. Credit agreements often require the borrower's (and often the administrative agent's) consent for lenders to assign their interests outside of the existing lender group, although the debtor typically loses its consent right during a bankruptcy proceeding and often during certain other serious events of default. In addition, to counter activist acquirors of bank debt, private equity sponsors often include in debt commitment letters and credit agreements of their portfolio companies a provision allowing them to prohibit assignments to a confidential list of "disqualified" potential lenders.[561] There is very little guidance on the subject

[561] Such a list of prohibited lenders was at issue in *LightSquared*, where the credit agreement prohibited assignment to certain companies, including DISH, EchoStar and their subsidiaries. DISH chairman Charles Ergen made a series of purchases of LightSquared debt through an investment vehicle, SPSO, before and after the company's May 2012 bankruptcy filing, ultimately accumulating a substantial position. The court concluded that SPSO's purchases did not technically violate the credit agreement, but nonetheless held that the "special purpose" of the special purpose vehicle "was to achieve an end-run around the Credit Agreement," in violation of the implied covenant of good faith and fair dealing. The court further found that SPSO used its blocking position to "control the conduct of the case itself" or to "subvert" a court-approved exclusivity termination arrangement to the detriment of other creditors. *In re LightSquared Inc.*, 511 B.R. 253, 360-61 (Bankr. S.D.N.Y. 2014). As a result, the court held that SPSO's claims would be equitably subordinated in an amount to be determined after further proceedings. Because the equity ultimately retained value following the auction, SPSO's claims were paid in full in cash.

of whether these provisions restricting assignments are enforceable in bankruptcy, or how a confidential list of prohibited lenders will be treated, including whether there is a risk of such lists becoming public.

Participations or total return swaps can be alternatives to an outright purchase or assignment of a claim. In a participation, the investor receives the economic rights that accompany a given claim without taking an assignment of the claim itself. In other words, the actual claim holder agrees to forward to the investor payments and distributions it receives from the debtor as a holder of the claim. Because the claim holder remains as a pass-through vehicle for payments to the investor, the investor becomes a creditor of the claim holder, not of the debtor directly, and assumes the counterparty risk of the claim holder in addition to the inherent credit risk of the debtor. During times of financial distress when there are bank and hedge fund failures, as in 2007-2008, this second layer of credit risk can be significant.

In a total return swap, a swap dealer pays the investor any distributions made in respect of the claim during the term of the swap in exchange for periodic payments by the investor calculated by applying a specified interest rate to the notional amount of the swap. At the end of the term of the swap, the dealer pays the investor the then-current market value of the claim and the investor pays the dealer the notional amount. The total return swap thus has many of the economic attributes of a financed purchase of the claim by the investor. The dealer typically purchases the underlying claim to hedge its position in the swap but is not required to do so. As with a participation, the investor under a total return swap is exposed to counterparty credit risk with respect to the dealer, in addition to the credit and market risk of the underlying claim. Buying a participation in or entering into a total return swap for a claim can be an effective means of sharing in the economics of the debt instrument when the purchaser either is not a permitted assignee of the underlying claim[562] or does not want to identify itself to the issuer. Additionally, a total return swap may be an effective means to finance the purchase of a claim equivalent. However, since a buyer of a participation or a

[562] There is a risk, however, that courts will scrutinize participations sold to prohibited assignees. In one case, a court enjoined a bank that was under common control with a competitor of the borrower that was a prohibited assignee from exercising any rights under a 90% participation in a loan, reasoning that the participation "might tend to give [the competitor] a competitive advantage." *Empresas Cablevision, S.A.B. de C.V.* v. *JPMorgan Chase Bank, N.A.*, 381 F. App'x 117, 118 (2d Cir. 2010).

party to a total return swap does not have a direct claim against the debtor,[563] the buyer may not have a "seat at the table" in negotiations with the debtor.

Credit agreements typically prohibit a lender from contracting with the holder of a participation for the right to direct the lender's vote or consent rights, subject to an exception for certain fundamental matters for which the consent of each lender is required. These matters typically include funding commitment increases, forgiveness of principal or interest, payment date postponements and changes to the percentage of holders required to amend or waive various provisions of a credit agreement. Thus, while the buyer of a participation in bank or other loan debt may obtain some significant rights in the acquired claim, such an indirect investor nevertheless will not be directly entitled to significant benefits and advantages that can only be gained by an outright purchase of the claim.

This said, as a practical matter, significant economic stakeholders in a company are often able to negotiate with a debtor whether they hold directly or derivatively through a participation or total return swap. For example, a seller of a participation may (and often does) vote as directed by the buyer of a participation, even if not obliged to do so under contract. And while a seller of a total return swap who owns the underlying debt instrument generally will not contract to vote as instructed by the buyer, the practice has tended toward consultation with the buyer, and often total return swap parties do participate directly in negotiations. Moreover, the parties to a total return swap may agree to physical settlement—meaning the seller may satisfy its obligations to the buyer by delivering the reference debt instrument. When that happens, the buyer of the total return swap will be converted into a direct claimant against the debtor.

c. *Other Investors Who May Not Have a Direct Claim Against the Debtor*

A related issue concerns the claims of those who believe they hold a security but actually do not have an interest, such as a party whose prime broker has loaned out the relevant security. While not common, putative holders of debt claims against firms seeking to reorganize occasionally have discovered that their securities were loaned out by their brokers and could not be voted until retrieved, which can prove nearly impossible where the company is in play and the security in question appears to be the fulcrum.

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[563] *See In re Okura & Co. (Am.), Inc.*, 249 B.R. 596 (S.D.N.Y. 2000) (participation agreement did not give rise to claim against debtor because it did not give participant right to enforce directly against debtor under non-bankruptcy law).

It is also possible for an investor to purchase a claim, generally in a securitized transaction, that does not make it a direct creditor of the debtor and able to participate in the bankruptcy case.

2. Service on the Official Committee of Unsecured Creditors

Beyond the simple right to be heard in the bankruptcy court, one of the most effective ways to participate in the reorganization process is to serve on the creditors' committee. With rare exceptions, an official committee of unsecured creditors is appointed soon after the commencement of every chapter 11 case. The members of the committee are selected by the U.S. Trustee at an organizational meeting that generally occurs within 10 days of the filing of a chapter 11 case. Pursuant to section 1102(b)(1), the committee generally will consist of the seven creditors holding the largest unsecured claims against the debtor (such as large trade creditors and bond indenture trustees), and may have more members in larger, more complex cases. In cases in which an informal committee of creditors was formed prior to the chapter 11 filing, that committee may continue to serve as the official committee if it is representative of unsecured claims generally.

Service on an official creditors' committee in a chapter 11 case enables committee members to be intimately involved in the reorganization process and to receive nonpublic information concerning the company. Additionally, committee members get the advice and benefit of counsel and financial advisors paid for by the debtor's chapter 11 estate. Generally, a debtor will provide significant operational, financial and strategic information to a committee on a confidential basis, and will consult with the committee on all matters of importance. A committee also is generally viewed by the bankruptcy court as the spokesperson for the interests of the unsecured creditors. In practice, the positions taken by a committee are often afforded significant weight by bankruptcy judges in making rulings affecting the interests of the estate and creditors generally.

While there are considerable informational and access advantages to service on a committee, such service also can have significant downsides for investors. The individuals who serve on a committee are restricted from using the nonpublic information they receive as committee members to engage in trading of a debtor's securities or the purchase or sale of claims against the debtor. As discussed in Part IV.D.3.b of this outline, however, it is possible to create a so-called "trading wall" to help reduce these risks. In addition, committee members cannot simply pursue their own interests, but, rather, must serve as fiduciaries for all unsecured creditors. Such fiduciary duties are also likely to restrict the ability of a committee member to acquire claims or to purchase assets in a section 363 sale.

In rare cases, the court may permit a committee member to remain on a committee and participate in a financing facility for a debtor. It is not unknown for a junior secured creditor, where the senior secured creditors are under-collateralized, to acknowledge, formally or informally, that it is effectively unsecured and seek to be added to the unsecured creditors' committee. Indeed, in several cases, such as the *Pliant* chapter 11 case in 2009,[564] U.S. Trustees have agreed to appoint such creditors to the unsecured creditors' committee.

In addition to the official creditors' committee, section 1102(a) authorizes the U.S. Trustee to appoint additional committees of creditors or equity security holders as it deems appropriate. Alternatively, upon motion the bankruptcy court may order appointment of additional committees, whose members will be appointed by the U.S. Trustee, to ensure adequate representation of creditors or equity holders. Courts will appoint additional official committees of creditors only in exceptional circumstances given that the incremental professional fees will be borne by the estate. It is not uncommon for subgroups of creditors (such as bondholders, retirees or trade creditors) to form "ad hoc" committees, particularly in larger and more complex chapter 11 cases (although certain retirees have a statutory right to an official committee).[565] These ad hoc committees have no statutory entitlement to reimbursement of the costs of counsel or professional advisors; they may, however, seek such reimbursement pursuant to section 503(b)(3)(D), which requires a rather difficult showing that the ad hoc committee made a "substantial contribution" to the reorganization.[566]

The appointment of an equity committee is warranted only where there is a reasonable prospect of a recovery to the equityholders. A finding that an estate is hopelessly insolvent will preclude the appointment of an official equity committee, whose professional fees would also be borne by the estate.

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[564] *Compare* Appointment of Official Comm. of Unsecured Creditors, *In re Pliant Corp.*, No. 06-10001-MFW (Bankr. D. Del. Mar. 9, 2006), ECF No. 72 (including Sun Chemical Corp. and Oxy Vinyls, LLP on Committee of Unsecured Creditors), *with* Schedules for Pliant Corp., Sch. D, at 76, *In re Pliant Corp.*, No. 06-10001-MFW (Bankr. D. Del. Mar. 9, 2006), ECF No. 314 (listing Sun Chemical Corp. and Oxy Vinyls, LP as creditors holding secured claims).

[565] *See* 11 U.S.C. § 1114(d).

[566] However, it is not uncommon for ad hoc committees of secured creditors to receive reimbursement of the cost of counsel and advisors as adequate protection. In very rare cases, even ad hoc committees of unsecured creditors have been compensated as part of a debtor's chapter 11 plan, although a decision in the *Lehman* bankruptcy found such an arrangement impermissible. *Davis* v. *Elliot Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 508 B.R. 283 (S.D.N.Y. 2014).

Conversely, where the debtor's economic circumstances support a real possibility of equity value, a shareholder request for appointment of an equity committee may succeed (as it did, *e.g.*, in 2016 for some oil and gas debtors with apparently rebounding prices in the energy sector). The willingness to order the appointment of an equity committee varies by district and among individual U.S. Trustees and judges, but is not available as of right. If an official equity committee is appointed, it acts in a fiduciary capacity for all holders of a debtor's common stock.

3. Duty to Disclose Information Relating to Acquired Claims

Investors in a distressed company, including would-be owners of a reorganized debtor, often act in concert in order to reduce expenses and/or maximize influence over a case. In doing so, such investors need to be cognizant not only of the potential securities law issues raised by joint action, but also of disclosure requirements imposed by Bankruptcy Rule 2019.

Rule 2019 requires any "entity" or "committee" representing multiple creditors or equityholders, including ad hoc groups of creditors, whether they define themselves as a committee or not, to file a statement setting forth, among other things, the identity of the members of the group and the nature and amount of their claims, as well as the quarter and year of purchase of any disclosable economic interests in certain circumstances. "Disclosable economic interests" are defined to include, among other things, claims, derivative instruments, options or "any other right or derivative right that grants the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."[567] Unlike the prior version of the rule, the current rule, as revised in 2011, does not require disclosure of the precise date of acquisition or the amount paid, although the court can order such disclosure when it deems it appropriate.[568]

C. Intercreditor Issues Affecting Holders of Bank and Bond Debt

1. Generally

The rights of holders of bank debt to enforce the provisions of the agreements governing their debt can be markedly different from the rights of noteholders. These differences derive from the disparate sources of their rights: In a credit

[567] Fed. R. Bankr. P. 2019(a)(1).

[568] Fed. R. Bankr. P. 2019 advisory committee's note.

agreement context, the loan documents alone govern the relationship among the lenders, the agent for the lenders and the borrower. By contrast, in the context of publicly issued bonds governed by an indenture, a federal statute—the Trust Indenture Act of 1939 ("TIA")—governs many of the key terms of the relationship among the noteholders, the trustee for the noteholders and the note issuer, with the indenture filling in the remaining terms. As a result, while a potential investor in bank debt can look to the terms of the loan documents alone to understand the rights it will be acquiring, a potential noteholder must understand both the applicable federal law and the provisions of the indenture. Finally, even if a credit agreement or indenture purports to give lenders or noteholders certain enforcement rights, an intercreditor agreement within a multi-lien capital structure can limit or alter the rights of junior secured creditors in meaningful ways.

2. Enforcement Rights of Bank Agent versus Lender

A credit agreement typically provides for the appointment by a syndicate of lenders of an administrative agent who is authorized to act on their behalf. The powers delegated to the administrative agent pursuant to a credit agreement materially affect the enforcement rights of individual lenders and the lenders as a group. Under New York law, which governs the vast majority of sophisticated U.S. credit agreements, an individual lender does not have the right to sue a borrower to enforce its rights under a credit agreement unless the credit agreement contains a specific provision providing for such a right.[569] Indeed, New York law considers individual creditor action to be precluded by language typically contained in credit agreements, which authorizes the administrative agent, acting upon the instructions of lenders holding a certain percentage of the debt, to declare the loan accelerated and pursue remedies against the borrower in an event of default.[570] The inability of the individual lender to act persists even after the maturity of the loan. In the *Delphi* chapter 11 case, for example, the bankruptcy court approved a forbearance agreement entered into by the first two tranches of the debtor-in-possession financing facility, and held that the individual lenders in the third tranche, which was part of the same facility, lacked standing to sue to enforce a payment default at the stated maturity. Lenders (or those purchasing the claims of lenders) also should be aware that a typical credit agreement protects the administrative agent in a number of ways, absolving the agent of any fiduciary

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[569] *See Beal Sav. Bank* v. *Sommer*, 865 N.E.2d 1210, 1218 (2007).

[570] *See id.*

or similar duties, including any duties to disclose to the lenders information relating to the borrower that is communicated to the administrative agent.[571] Courts applying New York law have vigorously enforced these provisions. For example, in a suit brought by syndicate lenders to Enron against their administrative agents alleging that the agents knew that Enron's disclosures were materially misleading, a federal court in New York held that "[i]n transactions between sophisticated financial institutions, 'no extra-contractual duty of disclosure exists'"[572] and "no obligation can be implied that would be inconsistent with other terms of the contractual relationship."[573]

3. Allocation of Enforcement Rights Between Indenture Trustee and Bondholders

The appointment by bondholders of an indenture trustee pursuant to a bond indenture is mandated by the TIA, which regulates contractual terms of publicly issued debt securities issued in amounts greater than $10 million, including bonds, notes and debentures. The provisions of the TIA, taken together with the terms of the indenture, combine to allocate the rights and powers of holders and the indenture trustee as to acceleration of the debt upon a default and the exercise of remedies.

As a baseline rule, the TIA provides that holders of not less than a majority of the principal amount of securities have the power to direct the trustee's enforcement of the noteholders' rights, to exercise noteholders' remedies and to consent to the waiver of any past default and its consequences. Most indentures supplement these rights by providing that holders of a majority of the principal amount of securities may rescind an acceleration.

On the other hand, most indentures give the indenture trustee the authority to act on its own in pursuing any available remedy to enforce the rights of the bondholders, accelerate the maturity of the debt upon a default and, in a bankruptcy proceeding, file a claim for the unpaid balance of the securities and cause the claim to be allowed. Most indentures, however, do not empower the

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[571] One commonly used form of credit agreement lacks any mechanism for the lenders to remove an agent even where an agent has allied with the borrower, such as where the borrower has engaged the agent to advise it.

[572] *UniCredito Italiano SpA* v. *JPMorgan Chase Bank*, 288 F. Supp. 2d 485, 498 (S.D.N.Y. 2003).

[573] *Id.* at 503.

trustee to consent on behalf of noteholders to a plan of reorganization affecting the securities or the rights of any holder, or to vote the claims of noteholders. The power to accelerate the debt in the first instance is often shared: Standard indentures give the trustee the authority to accelerate the maturity of the debt upon a default, of its own volition, but also allow holders of a certain percentage of the principal amount of securities (typically 25%) to declare an acceleration on their own, subject to deceleration upon a vote by a majority or some higher percentage.

Unlike a typical credit agreement, a typical indenture provides individual noteholders with the ability to pursue certain remedies on their own, albeit in very limited circumstances. An indenture contains what is customarily referred to as a no-action clause, which provides that, in order to exercise its own remedies, a holder first must follow a specific multi-step process: (1) the holder must give notice to the trustee of a continuing event of default, (2) holders of at least 25% in principal amount of the securities must make a request to the trustee to pursue a remedy, (3) either the trustee must give notice that it will not comply with such request or the trustee must not comply for a period of time (usually 15 to 30 days) from receipt of such notice and (4) holders of a majority in principal amount of securities must not give the trustee a direction inconsistent with such request. Notwithstanding this customary procedure, the TIA protects the rights of individual holders to institute collection actions for the payment of principal or interest due under the indenture on their own bonds, with certain limited exceptions.[574] Finally, the TIA requires, in the case of a default, that an indenture trustee exercise its rights and powers with the same degree of care and skill as a prudent person would exercise. The application of the prudent person standard is consistent with the philosophy of the TIA that under ordinary conditions the functions of the trustee are largely administrative, but under the special conditions that prevail during the continuance of an event of default, those functions may become active and executive as circumstances require in order to protect the interests of bondholders.[575]

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[574] 15 U.S.C. § 77ppp(b).

[575] *See generally* AM. BAR FOUND., COMMENTARIES ON INDENTURES 250 (1971), http://heinonline.org/HOL/P?h=hein.beal/comodip0001&i=1.

4. Intercreditor Agreements and Further Constraints on Creditor Action

Capital structures with multiple tiers of debt have become increasingly popular, and intercreditor agreements are often used to govern the relationships among secured creditors at various levels of seniority. As a result, when considering an investment in debt of a borrower whose capital structure includes multiple layers of secured debt, it is important for a potential investor to review the intercreditor agreement and to understand that a court may not enforce all of its protections for senior lienholders.

a. *Typical Intercreditor Agreements*

A first-lien lender's top priority in entering into an intercreditor agreement should be to ensure that it will receive payment of both principal and interest from the collateral ahead of the second-lien lenders. To further this objective, first-lien lenders often seek to freeze second-lien lenders' ability to enforce their remedies until the first-lien debt has been fully satisfied. First-lien lenders also often seek to limit second-lien lenders' ability to take certain actions that would interfere with the first-lien lenders' control over the collateral following a default or in bankruptcy. The contours of these intercreditor provisions are heavily negotiated and often include the following:

- A standstill provision, pursuant to which junior secured lenders agree not to take any enforcement actions against the collateral: (1) until the expiration of a specific time period (often 120-180 days, but sometimes until the discharge of the senior secured lenders' claims) from declaration of default, and (2) as long as the senior lenders are exercising and diligently pursuing their remedies on the shared collateral. The junior lenders also may agree not to contest any lien enforcement action against the collateral brought by the senior lenders. Such standstill provisions, at times, merely prevent junior lenders from proceeding against the collateral, leaving open the possibility that they will be able to accelerate the debt during the standstill period and thereby force a bankruptcy.

- An agreement by junior secured lenders not to object to or seek adequate protection in connection with any of the following transactions if they are consented to by the senior secured lenders:

    - use of cash collateral on which a first-lien lender has a lien;

- entry by the borrower into DIP financing up to an agreed maximum amount (or, less customarily, an uncapped amount), and the subordination of the junior liens to the DIP financing to the same extent that the senior liens are subordinated (including, in some cases, an agreement by the junior secured lenders not to propose competing DIP financing); and

- the sale of collateral free and clear of liens under section 363 of the Bankruptcy Code (including by way of credit-bidding the first-lien debt).

- A commitment by junior secured creditors not to seek relief from the automatic stay in a bankruptcy case of the borrower.

- An agreement by junior secured creditors not to contest any request by the senior secured lenders for adequate protection under section 362 of the Bankruptcy Code.

Often such prohibitions are qualified by permitting a second lienholder to raise any objection or seek any relief that would be available to an unsecured creditor and to be granted a junior lien on collateral on which a first priority lien has been granted to the first lienholder as adequate protection. Qualifications of this nature may help the restrictions described above survive judicial scrutiny by permitting a second lienholder some rights, while at the same time reserving to the first-lien creditors the specific prerogatives of a lienholder. However, such qualifications may under some circumstances permit second lienholders to circumvent the prohibitions in the intercreditor agreement by taking actions that do not directly involve the shared collateral but are adverse to the interests of first lienholders. For example, in the *Momentive* bankruptcy, the court found no violation of the intercreditor agreement where junior lienholders supported the debtors' objection to the senior lienholders' claim for a make-whole premium and the cramdown of the debtor's plan over the objections of the senior lienholders. The court reasoned that the intercreditor agreement "must be read to give the [junior lienholders] the unfettered right to act as unsecured creditors to object to the senior lien holders' claims" and that the junior lienholders' support for the cramdown plan was "the type of action . . . that any unsecured creditor would rightly take."[576]

[576] *In re MPM Silicones, LLC*, 518 B.R. 740, 751-52 (Bankr. S.D.N.Y. 2014), *aff'd*, 2019 WL 121003 (S.D.N.Y. 2019); *see also In re Bos. Generating, LLC*, 440 B.R. 302 (Bankr. S.D.N.Y.

Whatever the rights allocated, the existence of a multi-tiered lien structure is likely to complicate negotiations over a restructuring. Whereas unsecured bondholders typically fall into the same class as general unsecured creditors (and are, regardless of classification, entitled to identical treatment under the Bankruptcy Code), a second-lien tranche will create a new class between the first lienholders and the unsecured creditors, and thus constitute a new constituency with a separate interest in a valuation fight. This "Goldilocks" class (that is, not too senior, not too junior, but just right) may argue that the company is worth more than enough to cover the first lien, but not so much that the unsecured creditors are entitled to any value, thus making its claims the fulcrum. Moreover, the existence of a second lien and the rights attendant thereto may complicate the debtor's post-bankruptcy capital structure and exit financing. The second-lien class also may retain its own attorneys and, perhaps, financial advisors, all at the potential expense of the estate (*e.g.*, if the class turns out to be oversecured or successfully argues it has made a substantial contribution to the case). The existence of this class, or of multiple tiers of junior secured debt, can also complicate the prospective acquiror's hunt for the elusive fulcrum security.

b. *Enforceability in Bankruptcy of Intercreditor Agreements*

Section 510(a) of the Bankruptcy Code provides that "[a] subordination agreement is enforceable in a case . . . to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[577] As a result of section 510(a), the essential provisions of intercreditor agreements—those that establish lien priority or payment priority—are enforceable in bankruptcy.[578] However, it is not clear whether provisions that reach beyond payment and lien priority to waive basic bankruptcy rights will be upheld. For example, courts have not always been willing to enforce contractual provisions that purport to deprive a second-lien lender of the right to vote as it wishes on a plan of

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2010) (court construed intercreditor agreement not to prohibit second lienholders' objection to section 363 sale supported by first lienholders in part because second lienholders retained right to object as unsecured creditors).

[577] 11 U.S.C. § 510(a).

[578] Section 510(a)'s reference to "subordination agreement[s]" has been found to encompass both agreements subordinating rights to payment and agreements adjusting lien priority. *See In re Bos. Generating, LLC*, 440 B.R. 302, 318-20 (Bankr. S.D.N.Y. 2010) (lien priority); *In re Kobak*, 280 B.R. 164 (Bankr. N.D. Ohio 2002) (lien priority); *In re Best Prods. Co.*, 168 B.R. 35 (Bankr. S.D.N.Y. 1994) (payment subordination), *appeal dismissed*, 177 B.R. 791 (S.D.N.Y. 1995), *aff'd*, 68 F.3d 26 (2d Cir. 1995).

reorganization.[579] As a related matter, where an intercreditor agreement does not infringe on the second-lien lenders' right to vote on a plan, a bankruptcy court may enforce contractual terms that prevent second-lien lenders from challenging the priority of the first liens and from objecting to the plan of reorganization.[580]

In *Boston Generating*, the court held that an intercreditor agreement between first- and second-lien lenders was enforceable, but declined to interpret it as prohibiting the second-lien lenders from objecting to a section 363 sale that would result in enough to pay the first-lien debt nearly in full, but leave nothing for junior creditors. The intercreditor agreement provided that the first-lien lenders had the "exclusive right" to make decisions regarding the sale of collateral regardless of whether the debtors were in or out of bankruptcy, and that the second-lien lenders' "sole right" with respect to the collateral was to hold a lien, which would attach to the proceeds of any sale. Although the court stated that it went "against the spirit of the subordination scheme in the Intercreditor Agreement to allow the Second Lien Lenders to be heard and to attempt to block the disposition of the Collateral supported by the First Lien Agent," it nonetheless held that the second-lien lenders had standing to object both to the debtors' bidding-procedures motion and to their sale motion. The court based this decision on findings that (1) the agreement did not expressly mention objections to section 363 sales, as does the Model Intercreditor Agreement authored by the American Bar Association; (2) the agreement contained a clause preserving the second-lien lenders' rights to file pleadings as unsecured creditors; (3) most of the restrictions imposed on second-lien lenders applied upon an "exercise of remedies" by the first-lien lenders, which the parties agreed had not occurred; and (4) the second-lien lenders

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[579] *Compare In re Coastal Broad. Sys., Inc.*, 2013 WL 3285936, at *4-6 (D.N.J. June 28, 2013) (finding that junior creditors' prepetition assignment of voting rights to senior creditors pursuant to a subordination agreement was enforceable), *aff'd*, 570 F. App'x 188 (3d Cir. 2014); *In re Aerosol Packaging, LLC*, 362 B.R. 43, 47 (Bankr. N.D. Ga. 2006) (senior lender entitled to vote junior lender's claim in debtor's bankruptcy pursuant to express terms of subordination agreement), *and In re Curtis Ctr. Ltd. P'ship*, 192 B.R. 648, 659-60 (Bankr. E.D. Pa. 1996) (subordination agreement providing that senior lienholder was authorized to vote the junior lienholder's claims was enforceable under section 510(a) of the Bankruptcy Code), *with In re SW Bos. Hotel Venture, LLC*, 460 B.R. 38, 51-52 (Bankr. D. Mass. 2011) (intercreditor provision assigning plan voting rights from junior lender to senior lender unenforceable), *and In re 203 N. LaSalle St. P'ship*, 246 B.R. 325, 331 (Bankr. N.D. Ill. 2000) ("Subordination thus affects the order of priority of payment of claims in bankruptcy, but not the transfer of voting rights.").

[580] *See In re Ion Media Networks, Inc.*, 419 B.R. 585, 595 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 480 B.R. 494 (S.D.N.Y. 2012).

were on the "cusp" of a recovery and were not engaged in obstructionist behavior in objecting to the sale.[581]

In the event the secured creditors' liens are avoided in a fraudulent conveyance challenge, a further question arises as to whether the second lienholders are still contractually obligated under the intercreditor agreement to turn over any distributions they receive to the first lienholders. The answer to this question will likely turn on the particular language of the intercreditor agreement—some intercreditor agreements only cover lien subordination (*i.e.*, subordination of the right to proceeds of shared collateral), some only cover payment subordination (*i.e.*, subordination in right of payment) and many cover both.

Finally, note that while oversecured creditors are ordinarily entitled to postpetition interest and reimbursement of certain expenses, a multi-tiered lien structure can be documented in varying ways, which can have important ramifications for this principle. A "waterfall" provision under a security document may entitle particular creditors to payment before others but, if all of the creditors are governed by the same collateral documents and have a single lien that turns out to be worth less than the total secured debt, then even the "oversecured" first lien piece may not be entitled to postpetition interest from the debtor's estate or to treatment as an "oversecured" claim generally.[582] Thus, the first lienholders may not receive current interest payments during the pendency of the case. Instead, the first lienholders will have to collect such interest from the distribution to which the second lienholders would otherwise be entitled under the plan. For this reason, among others, most multi-level lien structures are documented through separate, albeit similar, security and other collateral documents.

c. *Postpetition Interest*

Many debtors have issued unsecured debt that is subject to contractual payment subordination under an intercreditor agreement or indenture. Such subordination provisions are clearly enforceable under section 510(a) of the Bankruptcy Code to the extent they provide that, upon default, principal and prepetition interest due to senior creditors must be paid before principal and prepetition interest are paid to subordinated creditors. However, disputes may arise over *postpetition* interest,

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[581] *Bos. Generating*, 440 B.R. at 320.

[582] *See First Fid. Bank, Nat'l Ass'n* v. *Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.)*, 134 B.R. 528 (Bankr. S.D.N.Y. 1991).

and whether senior creditors may receive such interest before subordinated creditors can recover anything. In a lengthy bankruptcy case, where substantial amounts of postpetition interest can accrue, subordinated creditors risk losing substantial value if senior creditors prevail on this point, which turns on the interpretation of section 510(a) as well as state law.

The courts are divided as to whether a pre-Bankruptcy Code principle known as the "Rule of Explicitness" survived the enactment of section 510(a). Under the Rule of Explicitness, in order to override the general rule that interest stops on the date of filing the petition, there must be an express statement in the subordination agreement that repayment of the junior creditors' principal and prepetition interest is subordinated to the senior creditors' postpetition interest.[583] Prospective buyers of debt are well-advised to analyze the applicable provisions of any subordination or intercreditor agreements prior to purchasing such claims. If the language does not clearly state that postpetition interest must be paid to the senior creditors before any principal or prepetition interest is paid to subordinated creditors, the potential for litigation over the issue exists.

D. Risks to Acquirors of Claims

1. Risks Accompanying Acquisition of Claims

A potential acquiror of a distressed company through the purchase of claims faces various risks. Some of those risks are unique to particular investors; others are inherent in the bankruptcy process or the accumulation of large claims positions. This subsection summarizes some of the risks to be considered prior to and in the process of accumulating claims.

a. *Investment at Risk*

First, and most obvious, is the risk that the value of claims against a debtor will fall. Although an investor's ultimate goal may be to own a controlling stake of

[583] *Compare In re Se. Banking Corp.*, 156 F.3d 1114, 1125-26 (11th Cir. 1998) (whether express statement is required turns on applicable state law), *and Silver Point Fin., LLC* v. *Deutsche Bank Tr. Co. (In re K-V Discovery Sols., Inc.)*, 496 B.R. 330, 336-37 (Bankr. S.D.N.Y. 2013) (describing Rule of Explicitness as "alive and well" and applying it to postpetition interest dispute), *with In re Bank of New England Corp.*, 364 F.3d 355, 364-65 (1st Cir. 2004) (express statement not required; general principles of contractual interpretation govern), *and HSBC Bank USA, Nat'l Ass'n* v. *Bank of N.Y. Mellon Tr. Co., Nat'l Ass'n (In re Bank of New England Corp.)*, 646 F.3d 90, 96-100 (1st Cir. 2011) (affirming bankruptcy court holding that subordination agreement did not subordinate junior debt to postpetition interest on senior debt).

the reorganized debtor's equity, there is always a possibility that the debtor will not be able to reorganize or that the value of the debtor will decline after an investment is made. While all investments bear such risk, investments in companies that are in or about to enter bankruptcy are subject to unique risks. Any bankruptcy case, even the shortest of proceedings, is accompanied by substantial uncertainty, generated by, among other things, bankruptcy law itself, the particular judge in whose hands the case is placed, and the stresses that bankruptcy places on the operation of any business. As discussed further below, bankruptcy proceedings can proceed slowly, imposing intervening operational and professional expenses of administration, borne by the estate, as well as a time-value loss. Moreover, some participants may find delay beneficial and will take steps designed to slow down the process further. For example, out-of-the-money creditors often prefer delay, whether as a tool to earn nuisance payments from in-the-money constituencies or in the hope that the debtor's reorganization value will eventually increase to the point that they are in the money. Meanwhile, other participants, such as governmental entities, may not be motivated by economic concerns at all and may therefore be indifferent to the passage of time.

Further compounding the risk of a bad investment in a troubled company is the reality that claims against a debtor may be purchased based on limited and/or unreliable financial information. For example, it will be difficult, if not impossible, to discern from public filings the extent of a retailer's likely exposure to lease rejection claims from its landlords or the value of any below-market leases the retailer may have. Similarly, a debtor's pension liabilities, the exact amount of which may be difficult to divine from public filings, may have a significant impact on any recovery.[584] Moreover, despite their disclosure obligations under the Exchange Act, which continue even during bankruptcy proceedings, companies in distress often fail to meet filing deadlines for financial statements, or have defective financial statements that can require restatement. Finally, a purchase of claims based on consolidated financials may not reveal intercompany indebtedness, which can also have a significant impact on relative recoveries in a complex capital structure, although such claims are often subordinated or waived.

[584] A full discussion of the treatment of pension and other post-employment benefits is beyond the scope of this outline, but it is important to be aware that resolution of these issues is often sought in bankruptcy cases, and can potentially dilute other creditor recoveries.

b. *Interest Rate and Prepayment Risks*

Section 502(b)(2) of the Bankruptcy Code provides for the disallowance of claims for "unmatured interest." The effect of that provision, at least in the case of an insolvent debtor, is to prevent unsecured or undersecured creditors from collecting interest on their claims that would otherwise accrue after a bankruptcy filing. By contrast, it is generally accepted that unsecured creditors are entitled to postpetition interest in a solvent case, although the recent trend is in favor of limiting the rate on such interest to the federal judgment rate.[585]

Oversecured creditors—*i.e.*, those with security interests in collateral with a higher value than the amount of their claims—are treated differently. Under section 506(b), oversecured creditors are entitled not only to postpetition interest, but also to any reasonable fees, costs, or charges (including attorneys' fees) provided for in the loan agreement.

One risk that may be faced by oversecured creditors is that, if the interest on their debt is higher than the prevailing market rate, the debtor may seek to refinance that debt without additional compensation. In low interest rate environments, chapter 11 debtors have sought to take advantage of favorable borrowing conditions to repay debt that, outside of bankruptcy, would be "noncallable" (*i.e.*, not subject to prepayment) or callable only with a premium.[586] Courts have consistently held that noncallable debt may be prepaid in bankruptcy,[587] and some courts have permitted such prepayment without awarding *any* damages to secured

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[585] *See, e.g.*, *Onick* v. *Cardelucci (In re Cardelluci)*, 285 F.3d 1231 (9th Cir. 2002); *In re Wash. Mut., Inc.*, 461 B.R. 200 (Bankr. D. Del. 2011).

[586] For a comprehensive discussion of the law governing prepayment of secured and unsecured debt in bankruptcy, *see* Scott K. Charles & Emil A. Kleinhaus, *Prepayment Clauses in Bankruptcy*, 15 AM. BANKR. INST. L. REV. 537 (2007). *See also, e.g.*, *U.S. Bank Tr. Nat'l Ass'n* v. *Am. Airlines (In re AMR Corp.)*, 485 B.R. 279 (Bankr. S.D.N.Y. 2013), *aff'd*, 730 F.3d 88 (2d Cir. 2013); *In re Calpine Corp.*, 356 B.R. 585 (S.D.N.Y. 2007).

[587] *See, e.g.*, *In re Calpine Corp.*, 356 B.R. at 597; *Cont'l Sec. Corp.* v. *Shenandoah Nursing Home P'ship*, 193 B.R. 769, 774-79 (W.D. Va. 1996), *aff'd*, 1996 WL 733941 (4th Cir. 1996); *In re Vest Assocs.*, 217 B.R. 696, 699 (Bankr. S.D.N.Y. 1998); *In re Skyler Ridge*, 80 B.R. 500, 502-09 (Bankr. C.D. Cal. 1987). In one outlier case, a bankruptcy court refused to allow a debtor to repay a debt that was subject to a no-call provision in connection with a motion to obtain debtor-in-possession financing. *See In re Premier Entm't Biloxi LLC*, 2007 Bankr. LEXIS 3939 at *8 (Bankr. S.D. Miss. Feb. 2, 2007). A subsequent decision in the case clarified that prepayment of the debt at issue was not prohibited where the debt was paid through the plan. *See In re Premier Entm't Biloxi LLC*, 445 B.R. 582, 633-34 (Bankr. S.D. Miss. 2010).

lenders,[588] or only awarding damages on an unsecured basis.[589] Thus, where a loan agreement does not include a prepayment fee as an alternative to a "no call," lenders may be forced to accept prepayment without receiving a claim for the damages resulting from reinvestment at a lower yield.

Loan agreements that provide for "makewhole" or prepayment fees increase the likelihood that lenders will be compensated for such repayment. While courts scrutinize the "reasonableness" of such fees under section 506(b), courts have regularly enforced prepayment fees that are correlated to the damages resulting from prepayment.[590] In some cases, courts have enforced prepayment fees even absent a showing of actual damages.[591]

Over the last several years, there has been substantial litigation regarding the effect of bankruptcy on the payment of makewholes. A major point of contention relates to whether amounts that would be payable to lenders outside of bankruptcy in the event of an early redemption are payable when, under the governing loan documents, the debt maturities have been accelerated due to a bankruptcy filing. Different federal appellate courts have reached different conclusions on this issue. In the *Momentive* case, the Second Circuit held that the automatic acceleration of secured loans as a result of a chapter 11 filing meant that the loans were not being redeemed at the debtor's option, but instead were being repaid post-maturity, and thus the makewhole was not payable.[592] The *Momentive* decision departed from the Third Circuit's 2016 decision in *Energy Future Holdings*, which held that the

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[588] *See, e.g.*, *In re Vest Assocs.*, 217 B.R. at 699-700; *Shenandoah Nursing*, 193 B.R. at 774.

[589] *See In re Premier Entm't Biloxi LLC*, 445 B.R. at 646; *In re Calpine*, 365 B.R. at 399-400.

[590] *See, e.g.*, *In re Imperial Coronado Partners*, 96 B.R. 997, 1001 (B.A.P. 9th Cir. 1989); *In re Schwegmann Giant Supermarkets P'ship*, 264 B.R. 823, 828-31 (Bankr. E.D. La. 2001); *In re Anchor Resolution Corp.*, 221 B.R. 330, 340-41 (Bankr. D. Del. 1998).

[591] *See, e.g.*, *Katzenstein* v. *VIII SV5556 Lender, LLC (In re Saint Vincent's Catholic Med. Ctrs. of N.Y.)*, 440 B.R. 587, 594-95 (Bankr. S.D.N.Y. 2010); *In re Vanderveer Estates Holdings, Inc.*, 283 B.R. 122, 131-34 (Bankr. E.D.N.Y. 2002); *In re Hidden Lake Ltd. P'ship*, 247 B.R. 722, 729 (Bankr. S.D. Ohio 2000); *Noonan* v. *Fremont Fin. (In re Lappin Elec. Co.)*, 245 B.R. 326, 328-30 (Bankr. E.D. Wis. 2000); *In re Fin. Ctr. Assocs. of E. Meadow, L.P.*, 140 B.R. 829, 835-36 (Bankr. E.D.N.Y. 1992).

[592] *In re MPM Silicones LLC*, 874 F.3d 787 (2d Cir. 2017).

debtors' decision to refinance secured debt in bankruptcy was a voluntary "redemption" subject to a makewhole under New York law.[593]

These divergent decisions, each applying New York law, have led to further litigation and uncertainty. At the same time, however, the *Momentive* decision has spawned a trend in which lenders to distressed companies have inserted "*Momentive*-proof" language in their loan documents—stating expressly that a makewhole will be payable regardless of acceleration and regardless of bankruptcy. While *Momentive*-proof language does not remove all issues regarding the enforceability of a makewhole in bankruptcy, it does provide a contractual mechanism to avoid the split in authority described above and to mitigate bankruptcy risk for lenders to distressed companies.[594]

c. *Substantive Consolidation Risk*

The "substantive consolidation" of two or more affiliated debtors—so that their assets and liabilities are pooled for the purpose of distribution—is a tool that may be used when the financial affairs of separate debtors are entangled. But the law has been unfavorable to the use of substantive consolidation. A proponent of substantive consolidation generally must show either (1) that prepetition, the entities for whom substantive consolidation is sought "disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity," or (2) that "postpetition their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[595]

Notwithstanding these legal barriers, debtors often propose to consolidate members of their corporate family. The effect of substantive consolidation on creditor recoveries varies depending on where a creditor is situated in the capital

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[593] *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).

[594] *See, e.g.*, *In re 1141 Realty Owner LLC*, No. 18-12341, slip op. at 14 (Bankr. S.D.N.Y. Mar. 18, 2019), ECF No. 132 ("One way to ensure that a make-whole premium is payable even after acceleration is to say so explicitly. Another way to ensure that the make-whole premium is payable even after acceleration is to render acceleration irrelevant and . . . make the premium contingent on any post-default payment. Deeming the post-default payment to be a 'voluntary prepayment' does not forfeit the Yield Maintenance Default Premium; it confirms the parties' intent that it must be paid even if it is not an actual prepayment.").

[595] *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005); *see also In re Augie/Restivo Baking Co.*, 860 F.2d 515, 518 (2d Cir. 1988).

structure and against which entities it has claims. Specifically, substantive consolidation may benefit creditors who do not have direct claims against a large portion of a company's assets because, for example, their claims are against a parent company and not guaranteed by its operating subsidiaries. Conversely, creditors with claims against relatively well-capitalized entities may be harmed by substantive consolidation because it may make claims against less-capitalized entities *pari passu* with their claims. In light of the varying effects substantive consolidation can have on creditor recoveries, the threat of substantive consolidation can have a meaningful impact on the negotiated outcome of a case. In the *Lehman Brothers* chapter 11 case, an ad hoc group of senior bondholders with claims against the relatively asset-poor parent holding company proposed a plan that would have substantively consolidated the holding company with certain of its better-capitalized subsidiaries. The threat of substantive consolidation led to a negotiated settlement in which distributions were adjusted to reflect an implied 20% risk of substantive consolidation, resulting in greater recoveries for creditors of the parent holding company than they otherwise would have received.

d. *Risk of Disabilities that May Travel with Transferred Claims*

The general rule applied by bankruptcy courts is that a claim "in the hands of a purchaser has the same rights and disabilities as it did in the hands of the original claimant."[596] Although the case law is clear that claim purchasers generally acquire the same rights *against* the debtor as the transferor had, the law is less settled as to whether *disabilities* of the transferor also travel with the claim. Disabilities of the transferor that might affect the transferee's rights include avoidance of claims as fraudulent transfers,[597] objections to allowance under section 502(d) of the Code, and equitable subordination of claims under section 510(c).

Section 502(d) mandates that a creditor's claim be disallowed until the creditor has repaid any avoidable transfers—*i.e.*, preferences or fraudulent conveyances. While those transfers may be unrelated to the transferred claim, there is

[596] *See generally* Chaim J. Fortgang & Thomas Moers Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 CARDOZO L. REV. 1, 13 & n.74 (1990).

[597] Fraudulent transfers are discussed in Part I.B.1.a.

substantial risk that the claim could remain subject to disallowance in the hands of the transferee if the transferor has not repaid an avoidable transfer.[598]

Another disability that can potentially affect a transferee's rights is equitable subordination. Section 510(c) of the Bankruptcy Code permits a bankruptcy court to "equitably subordinate" all or part of a particular creditor's claim to the claims of other creditors. As discussed in more detail in Part I.B.3.b.iii, equitable subordination is an extraordinary remedy that is available when a creditor has engaged in inequitable conduct—such as fraud—that injured other creditors.[599] The issue of whether the inequitable conduct of a transferor could serve as a basis for the equitable subordination of claims held by an innocent transferee was the subject of consideration in the Bankruptcy Court for the Southern District of New York in *In re Enron Corp*.[600] The bankruptcy court had ruled that the transferee of a claim is subject to an equitable subordination claim that could be asserted against the transferor—reasoning that "[t]here is no basis to find or infer that transferees should enjoy greater rights than the transferor."[601] On appeal, the district court vacated the bankruptcy court's ruling, holding that "[e]quitable subordination and disallowance are personal disabilities of the claimant and travel with the claim only when the claim is assigned, not when it is sold."[602] The

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[598] *Compare Section 1102(a)(1) Comm. of Unsecured Creditors* v. *Williams Patterson, Inc. (In re Wood & Locker, Inc.)*, 1988 U.S. Dist. LEXIS 19501, *8-9 (W.D. Tex. June 17, 1988) (transferee's claim not disallowed based on transferor's receipt of preference), *with In re Metiom, Inc.*, 301 B.R. 634, 642-43 (Bankr. S.D.N.Y. 2003) (transferee's claim could be disallowed based on the transferor's receipt of preference).

[599] *See Pepper* v. *Litton*, 308 U.S. 295, 304-06 (1939) (bankruptcy court has exclusive jurisdiction over subordination, allowance and disallowance of claims, and may reject a claim in whole or in part according to the equities of each case). Some courts have determined that they have the power to disallow, rather than merely subordinate, a claim on equitable grounds, although the question remains controversial. *See, e.g., Koch Ref.* v. *Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1350 (7th Cir. 1987) ("If the court finds that [transactions between the debtor and an insider] are inherently unfair, it is within its equitable powers to subordinate or disallow the insider's claims pursuant to section 510(c)."); *Adelphia Recovery Tr.* v. *Bank of Am., N.A.*, 390 B.R. 64, 76 (S.D.N.Y. 2008) (concluding that equitable disallowance remains a viable remedy). *But see In re LightSquared Inc.*, 504 B.R. 321, 339 (Bankr. S.D.N.Y. 2013) (disagreeing with *Adelphia* and ruling that the Bankruptcy Code does not permit equitable disallowance of claims that are otherwise allowable under section 502(b)).

[600] 333 B.R. 205 (Bankr. S.D.N.Y. 2005), *vacated*, 379 B.R. 425 (S.D.N.Y. 2007).

[601] 333 B.R. at 223.

[602] *In re Enron Corp*., 379 B.R. at 439.

district court pointed out that under non-bankruptcy law, transferees can enjoy greater rights than their transferor in some instances.[603] The district court remanded the case to the bankruptcy court for additional fact-finding on whether the transfer was an assignment, which would be subject to equitable subordination, or a true sale, which would not. The case then settled. This left the district court's opinion, which provides little practical guidance on how to effectuate a "sale" as opposed to an "assignment," in place.

However, this distinction between claims transferred via "assignment" and "sale" has been criticized by other courts. Most notably, in *In re KB Toys*, the Third Circuit Court of Appeals stated that "the state law on which [*Enron*] relies does not provide a distinction between assignments and sales."[604] Noting that claims purchasers are typically sophisticated entities who are aware of and account for the risk of disallowance through the price paid for a claim and indemnities, the Third Circuit held that "because § 502(d) permits the disallowance of a claim that was originally owned by a person or entity who received a voidable preference that remains unreturned, the cloud on the claim continues until the preference payment is returned, regardless of whether the person or entity holding the claim received the preference payment,"[605] or whether the transfer took the form of an assignment or a sale. And even in the Southern District of New York, subsequent bankruptcy court decisions have followed *KB Toys* rather than *Enron*.[606]

Given the likelihood that disabilities will travel with a claim, it is advisable for claims purchasers to seek indemnity agreements from their transferors (such as an indemnity against or representation and warranty with respect to the existence of defenses to the transferred claims).

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[603] *Id.* at 436 (applying principles of the law of sales, where a purchaser can attain more rights than the seller has). *See, e.g.*, N.Y. U.C.C. § 8-202(d) (all defenses of the issuer of a security, with enumerated exceptions, are ineffective against a purchaser for value who has taken the security without notice of the particular defense).

[604] 736 F.3d 247, 254 n.11 (3d Cir. 2013).

[605] *Id*. at 253-54.

[606] *See In re Motors Liquidation Co.*, 529 B.R. 510, 572 n.208 (Bankr. S.D.N.Y. 2015), *aff'd in pertinent part and rev'd in part on other grounds*, 829 F.3d 135 (2d Cir. 2016).

e. *Certain Tax-Related Risks*

(i) Restrictions on Trading

The claims market in large chapter 11 cases often is constrained by court orders that seek to protect a debtor's NOLs. NOLs generally are an excess of tax deductions over taxable income in a particular year, and are valuable because they can be applied against taxable income in other years.

Section 382 of the Internal Revenue Code limits a company's ability to use NOLs and certain built-in losses after an ownership change. The annual limitation (*i.e.*, the maximum amount of taxable income that can be offset by NOLs and other pre-ownership-change losses) generally is the value of the stock of the company immediately before the date of the ownership change multiplied by a prescribed rate.[607] In general, an ownership change occurs under section 382 if the percentage of stock owned by one or more 5% shareholders (as specifically defined for purposes of this rule) has increased by more than 50 percentage points over the lowest percentage of stock owned by those shareholders during a specified testing period (usually three years).[608] As a very general matter, in determining whether an ownership change has taken place, all shareholders that own less than 5% of the stock in a company are treated as a single shareholder.

Because over-leveraged debtors often emerge from bankruptcy by distributing a controlling equity interest to their creditors, section 382's general change of ownership rule could have a drastic effect on many chapter 11 debtors. However, there is a bankruptcy exception pursuant to which the section 382 limitation will not apply if (1) the company is under the jurisdiction of the bankruptcy court and (2) the shareholders and "qualified creditors" of the debtor own, as a result of having been shareholders and such creditors, at least 50% (by vote and value) of the stock in the reorganized debtor.[609] A "qualified creditor" is a creditor that receives stock in the reorganized debtor in satisfaction of debt either (1) held at

[607] 26 U.S.C. §§ 382(b), (e)(1).

[608] 26 U.S.C. § 382(g).

[609] 26 U.S.C. § 382(l)(5). Debtors may elect out of section 382(l)(5). Many consider doing so because, absent the election, if a second ownership change occurs within two years, no amount of pre-change losses can be used to offset taxable income for post-change years. If section 382(l)(5) does not apply, for purposes of determining the section 382 limitation the value of the corporation is increased by the value resulting from surrender or cancellation of creditors' claims. 26 U.S.C. § 382(l)(6).

least 18 months prior to the commencement of the bankruptcy case or (2) that arose in the ordinary course of the debtor's business and that has been held by the creditor at all times.[610] Under a special rule, a creditor is also deemed to be a "qualified creditor" if, immediately after the ownership change, it is not a 5% shareholder in the debtor (and is not an entity through which a 5% shareholder owns an indirect interest).[611] Therefore, the existence of creditors that purchase claims less than 18 months before the company files for bankruptcy and receive 5% or more of the stock of the reorganized debtor may jeopardize the availability of this exception.

Chapter 11 debtors that wish to avail themselves of this exception commonly seek (and obtain) early in their cases orders that (1) prevent creditors from purchasing claims to the extent that such claims would convert into 5% or more of the stock of the debtor or (2) permit the debtor to require creditors to "sell down" claims acquired after entry of an NOL-protection order to the extent such claims endanger the debtor's NOLs.[612] Thus, if two creditors each purchase 30% of the debtor's fulcrum security after entry of a NOL-protection order, they may be required to sell down those positions or, if they fail to do so, forfeit part of the equity stake they would otherwise receive in the reorganized debtor.

The legality of NOL-protection orders is largely untested. In *United Airlines*,[613] the Seventh Circuit suggested that the only arguable basis for such orders—namely, the Bankruptcy Code's prohibition on acts "to exercise control over property of the estate"—is not legally sufficient, because the mere purchase of claims against a debtor is not an act to "control" estate property. Nonetheless, in the 2006 bankruptcy of Dana Corp., following a five-month battle between Dana and several groups of creditors that argued that the court did not have such authority, the court entered an NOL-protection order that contained the standard

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[610] 26 C.F.R. § 1.382-9(d)(1)-(2).

[611] 26 C.F.R. § 1.382-9(d)(3).

[612] Debtors often also seek orders to limit trading with respect to their stock in order to avoid an ownership change in connection with the consummation of the plan of reorganization. *See, e.g.*, Motion for Interim and Final Orders Establishing Notification Procedures and Approving Restrictions on Certain Transfers of Stock of, and Claims Against, the Debtors, *In re PG&E Corp.*, No. 19-30088 (Bankr. S.D.N.Y. Jan. 29, 2019), ECF No. 10.

[613] *In re UAL Corp.*, 412 F.3d 775, 778-79 (7th Cir. 2005).

sell-down provisions.[614] In light of the uncertainty regarding NOL-protection orders, there has been a trend toward more limited orders that allow free trading of claims while reserving the debtor's right to seek a "sell-down" at the plan stage if the plan ultimately relies on section 382(l)(5). So long as courts in major jurisdictions continue to enter NOL-protection orders, strategic investors will be subject to the risk of pressured sales.

(ii) Risks from Actual or Deemed Exchange of Debt

A creditor may recognize taxable gain or loss from an actual or deemed exchange of debt as the result of a workout or debt restructuring.[615] If the modified debt results in a "significant modification" for tax purposes, and the exchange does not qualify as a tax-free recapitalization,[616] a creditor will recognize gain or loss as if it sold the old debt for an amount equal to the "amount realized," which is the issue price of the new debt. Under certain circumstances, a change in maturity date and/or interest rate, a change in the subordination of the debt or the security underlying the debt, or a change in obligor can result in a significant modification and, therefore, a deemed exchange for tax purposes, even without an actual exchange of the underlying debt.[617] These and related issues are more fully explored in Part I.A.2.c and Part I.B.4.c.viii.

2. Risks from Insider or Fiduciary Status

In a distressed environment where debt trades well below par, insiders or affiliates of an issuer may wish to purchase claims of that issuer either as a long-term investment or as a method to increase their stake or seniority in a company experiencing distress. But access to information about a debtor can subject an acquiror of claims to various risks and obligations, some of which are unique to the bankruptcy process.

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[614] *See* Dan A. Kusnetz, *Loss of Control: The Clash of Codes in the Battle Over a Debtor's Net Operating Losses* (Tax Review, Paper No. 243, Nov. 13, 2006).

[615] If the creditor has properly claimed a bad debt deduction with respect to the old debt in prior taxable years, the gain may be offset by an amount equal to the excess of the creditor's basis in the old debt over the fair market value of the debt (or, if greater, the amount of debt recorded on the creditor's books and records). 26 C.F.R. § 1.166-3(a)(3). This effectively prevents a reversal of the earlier deduction.

[616] Tax-free reorganizations are discussed in Part III.B.9 of this outline.

[617] *See* 26 C.F.R. § 1.1001-3.

Historically, recovery to an insider was limited to the cost at which it purchased its claims.[618] While under current law an insider's recovery is not likely to be *per se* limited to the amount of its investment in a claim, the equitable powers of the bankruptcy court still may be used to limit recovery through the doctrine of equitable subordination.[619] Particular actions an insider might take that could be deemed inequitable by a court include, among others, the usurpation of a corporate opportunity, the use of material nonpublic information, or the use of a previously undisclosed position to influence the bankruptcy process.

In this section, we consider the circumstances that give rise to fiduciary or insider status and the potential sanctions faced by fiduciaries and insiders who trade in claims or interests. In the next section, we address ways in which an investor can mitigate the risks associated with possession of material nonpublic information in particular.

a. *Who Is an Insider or a Fiduciary Under the Bankruptcy Code?*

An "insider" is "one who has a sufficiently close relationship with a debtor that [its] conduct is . . . subject to closer scrutiny than those dealing at arm's length with the debtor."[620] The Bankruptcy Code provides a nonexclusive list of insiders that includes officers, directors, affiliates, general partners and persons that are "in control of the debtor."[621] To determine whether a person is in control of the debtor, courts generally will look at whether the person has "day-to-day" control of the debtor.[622] Exertion of lesser influence generally will not be sufficient to confer insider status; however, it is possible that a lesser degree of control, if used to extract a better than arm's-length deal with the debtor, may be sufficient for a person to be deemed an insider with respect to that specific transaction, thereby

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[618] *See Young* v. *Higbee Co.*, 324 U.S. 204, 213 (1945) ("The money [the investors] received in excess of their own interest as stockholders was not paid for anything they owned.").

[619] Discussed in detail in Parts I.B.3.b.ii and IV.D.1.c of this outline.

[620] *See* S. REP. NO. 95-989, at 25 (1978); H.R. REP. NO. 95-595, at 312 (1979).

[621] *See* 11 U.S.C. § 101(31).

[622] *See, e.g.*, *Official Comm. of Unsecured Creditors* v. *Tennenbaum Capital Partners, LLC* (*In re Radnor Holdings Corp.)*, 353 B.R. 820, 847 (Bankr. D. Del. 2006); *Official Comm. of Unsecured Creditors* v. *McConnell (In re Grumman Olson Indus., Inc.)*, 329 B.R. 411, 428 (Bankr. S.D.N.Y. 2005).

triggering the longer one-year lookback period for preferences, as compared to 90 days for transactions with non-insiders.[623]

Findings of insider status based on control have, at times, even extended to lenders. For example, the Third Circuit, in an adversary proceeding related to the bankruptcy of broadband provider Winstar Communications, found that Winstar's lender and supplier, Lucent Technologies, was liable as an insider for preferential payments because Lucent exercised control over Winstar's day-to-day operations, including controlling the expansion of Winstar's broadband network and forcing the purchase of unneeded equipment from Lucent.[624]

A notable source of fiduciary status is membership on an official committee of unsecured creditors. Such committees and their members owe fiduciary duties to their constituencies. In addition, certain insiders such as officers and directors owe fiduciary duties to a debtor under applicable state laws.

When an investor seeking to acquire a debtor serves on an official committee or otherwise has a close relationship with or has received material nonpublic information from the debtor, that potential acquiror needs to consider the implications of its status under both bankruptcy and non-bankruptcy law.

b. *Insider Trading: When Do Federal Securities Anti-Fraud Rules Apply to Debt Trading?*

In order for the prohibition against insider trading under the federal securities laws to apply, the instruments being traded must be "securities." Neither trade claims nor interests in bank debt are typically considered to constitute "securities" for purposes of the federal securities laws.[625] Because of this, the consensus has

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[623] *See Schubert* v. *Lucent Techs., Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382, 395-96 (3d Cir. 2009) (citing *In re U.S. Med., Inc.*, 531 F.3d 1272, 1277 n.5 (10th Cir. 2008)) (noting that there are "non-statutory insiders," and that the requisite level of "control" need not rise to the level of "actual, legal control over the debtor's business" or "the ability to 'order, organize or direct'" the debtor's operations, because, if that were the test it would be no broader than the category, enumerated in section 101(31), of a "person in control of the debtor").

[624] *See Shubert* v. *Lucent Techs., Inc. (In re Winstar Commc'ns, Inc.)*, 348 B.R. 234, 279 (Bankr. D. Del. 2005) ("The true test of 'insider' status is whether one's dealings with the debtor cannot accurately be characterized as arm's-length."), *aff'd*, 2007 WL 1232185 (D. Del. Apr. 26, 2007), *aff'd in part and modified in part*, 554 F.3d at 382.

[625] For a widely cited case holding that a loan participation agreement among sophisticated financial institutions did not generate covered "securities," see *Banco Español de Credito* v. *Sec. Pac. Nat'l Bank*, 973 F.2d 51, 55-56 (2d Cir. 1992). It is possible, however, that other courts

been that SEC Rule 10b-5 (restricting insider trading) does not apply to trading in such claims and interests. Bonds, however, are securities covered by the federal securities laws, and the risk that a remedy may be available under Rule 10b-5 is heightened where a plaintiff can allege that the person trading while in possession of material nonpublic information violated a fiduciary or other duty.[626]

Although bank debt is not typically considered a security, transactions in bank debt can still be subject to common law claims of wrongdoing. Trading with a sophisticated counterparty through the use of a so-called "big boy" letter may help to shield an insider from common law fraud liability. However, "big boy" letters may present problems of their own, or be inadequate to protect the parties from legal risk, as discussed in Part IV.D.3.c of this outline.

It also bears mention that many investment firms have adopted a safe, but conservative, policy of treating bank debt as if it were a security for trading purposes, eschewing trading while in possession of potentially material nonpublic information under any circumstances.

c. *Bankruptcy-Specific Remedies—the Papercraft Case*

An insider that purchases discounted claims in breach of its fiduciary duties to the debtor or the debtor's creditors or shareholders may be subject to court-imposed sanctions.[627] The Third Circuit's *Papercraft* decision—which held that fiduciaries that trade in claims risk disgorgement of profits and equitable subordination of their claims under section 510(c) of the Bankruptcy Code—is the

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applying the legal test used in *Banco Español de Credito* (previously set forth by the Supreme Court in *Reves* v. *Ernst & Young*, 494 U.S. 56, 65 (1990)) could reach a different conclusion with respect to particular bank debt facilities or participations therein. Indeed, in *Banco Español de Credito*, Judge Oakes would have held that the debt participations at issue were in fact "securities," 973 F.3d at 60 (Oakes, J., dissenting), and the majority cautioned that "the manner in which participations in [the debt] instrument are used, pooled, or marketed might establish that such participations are securities," *id.* at 56.

[626] *See also* Part I.B.3.b.iii (discussing equitable subordination of claims). *But cf. Alexandra Glob. Master Fund, Ltd.* v. *IKON Office Sols., Inc.*, 2007 WL 2077153 (S.D.N.Y. July 20, 2007) (finding Rule 10b-5 remedy unavailable against issuer that repurchased convertible notes while in possession of material nonpublic information because issuer owed no fiduciary or other analogous duty to selling noteholders).

[627] *See* Part IV.D.2 (discussing risks to insiders who purchase claims).

leading case in this area.[628] In *Papercraft*, Citicorp Venture Capital, a 28% equityholder in Papercraft Corp., held a seat on the board of directors of each of Papercraft, Papercraft's corporate parent, and two of Papercraft's subsidiaries.[629] After Papercraft filed its chapter 11 petition and an initial plan of reorganization, Citicorp Venture—without prior disclosure—purchased approximately 40.8% of Papercraft's unsecured claims at a substantial discount, eventually leading to the filing of a second plan of reorganization (a cash offer by Citicorp Venture to buy certain assets of the debtor).[630] At the same time, Citicorp Venture, by virtue of its board representation, received confidential, nonpublic information about Papercraft's financial stability and assets.[631]

In deciding an objection to the allowance of Citicorp Venture's claims, the bankruptcy court ruled that Citicorp Venture's claims would be disallowed to the extent they exceeded their purchase price, but did not otherwise subordinate the claims.[632] On appeal, the Third Circuit went further, holding that fiduciaries that trade in claims risk not only disgorgement of profits but also equitable subordination of their claims. The court concluded that, in the circumstances presented, equitable subordination was an appropriate remedy given the bankruptcy court's findings that the debt was purchased: (1) for the dual purpose of making a profit for Citicorp Venture and enabling Citicorp Venture to influence the reorganization; (2) with the benefit of nonpublic information; and (3) without disclosure.[633] The court also emphasized that any subordination remedy must be proportional to the level of harm suffered by the creditors.[634] The Third Circuit remanded the case to the bankruptcy court to determine whether subordination beyond the level necessary to disgorge profits was justified given an examination of the specific harms caused by Citicorp Venture's actions upon

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[628] *Citicorp Venture Capital, Ltd.* v. *Comm. of Creditors Holding Unsecured Claims (In re Papercraft Corp.)*, 160 F.3d 982, 991 (3d Cir. 1998).

[629] *See Comm. of Creditors Holding Unsecured Claims* v. *Citicorp Venture Capital, Ltd. (In re Papercraft Corp.)*, 187 B.R. 486, 491 (Bankr. W.D. Pa. 1995), *rev'd*, 211 B.R. 813 (W.D. Pa. 1997), *aff'd*, 160 F.3d at 982.

[630] *Id.* at 492, 498.

[631] *Id.* at 492-93.

[632] *Id*. at 501.

[633] *In re Papercraft Corp.*, 160 F.3d at 987.

[634] *Id.* at 991.

the creditors who would benefit from the subordination.[635] On remand, the bankruptcy court held that the record supported the subordination of Citicorp Venture's claim in addition to disgorgement of profit.[636]

Although *Papercraft* has not recently been applied to equitably subordinate claims held by insiders or fiduciaries, it continues to be cited as a potential basis for doing so,[637] and warrants caution for insiders and fiduciaries trading in a debtor's claims. Insiders should be particularly cautious about purchasing claims if the issuer has defaulted or a default is believed to be imminent, especially if the insider is in possession of nonpublic information.

If insiders do purchase claims, they should take certain precautions, such as presenting the opportunity to purchase claims to the board of directors or obtaining approval from independent members of the board prior to making the purchase. Insiders should also consider disclosing their identities to the seller and the seller's broker. Finally, insiders should be careful to follow practices for complying with applicable federal securities laws, such as adhering to company trading windows and verifying that the company is not in possession of material nonpublic information, and a company also should consider disclosing that an insider is considering purchasing debt.

3. Potential Safeguards Against Insider Trading Risk

To avoid subordination, recovery limitation, fraud liability and other potential negative consequences of buying or selling claims while in possession of nonpublic information, a potential acquiror may choose both to avoid any access to nonpublic information until it has accumulated all of the claims or interests it needs to execute its strategy, including by remaining on the "public side" of a debt syndicate, and to refrain from liquidating its position until all such initially nonpublic information has become public. Alternatively, an acquiror can seek to limit its risk by, among other things, implementing "trading walls" and/or entering into contracts with its counterparties that are aimed at preventing any

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[635] *Id.* at 991-92.

[636] *Comm. of Creditors Holding Unsecured Claims* v. *Citicorp Venture Capital, Ltd. (In re Papercraft Corp.)*, 247 B.R. 625, 628 (Bankr. W.D. Pa. 2000), *aff'd in pertinent part*, 2002 WL 34702177 (W.D. Pa. Feb. 20, 2002), *aff'd*, 323 F.3d 228 (3d Cir. 2003).

[637] *See, e.g.*, *In re Aéropostale, Inc.*, 555 B.R. 369, 412 (Bankr. S.D.N.Y. 2016); *In re Basil St. Partners, LLC*, 2012 WL 6101914, at *25 (Bankr. M.D. Fla. Dec. 7, 2012); *In re Surfango, Inc.*, 2009 WL 5184221, at *13 (Bankr. D.N.J. Dec. 18, 2009).

claims of improper trading. Whatever methods are chosen, issuers and investors are strongly cautioned to use the highest levels of care to avoid even the appearance of impropriety.

a. *"Public Side" Versus "Private Side"*

Holders of bank debt are frequently in a position to receive nonpublic information. To allow such holders to maintain the ability to trade, bank syndicates are generally managed so that an investor may opt out of receiving private-side information. Both public-side and private-side information is provided subject to express confidentiality requirements usually set forth in the applicable loan agreements. The biggest difference between public-side and private-side information is the completeness of the information received, with private-side information understood to contain or potentially contain material nonpublic information.

If a loan investor chooses to receive private-side information, it should then (1) consider trading only with counterparties with the same type of access to information, (2) be prepared to accept restrictions against trading in the issuer's other obligations constituting securities, and (3) depending on the sensitivity of the private-side information, consider requiring counterparties to enter into "big boy" letters, as further discussed below in Part IV.D.3.c. Additionally, private-side investors who are part of a "steering committee" of bank lenders who receive more sensitive information than the broader private-side group, or who are involved actively in negotiating a restructuring that has not yet been disclosed to the broader private-side group, should consider more stringent trading limitations, such as only trading with other "steering committee" members, or not trading at all, while the information disparity exists. Certain information may also be designated for review by outside advisors on behalf of the steering committee; this safeguard allows the committee to benefit from its advisors' substantive conclusions without having been directly exposed to the material nonpublic information.

It is important for each investor to establish clear internal standards regarding the authority to accept confidentiality restrictions and sign confidentiality agreements. This will limit the risk that employees and officers may either informally agree to confidentiality restrictions or be accused of having done so. Limiting authority in this way will better position an investor to make these choices and to adopt effective compliance measures to control and monitor access to, and avoid misuse of, material nonpublic information.

It is also important for each investor to bear in mind that, notwithstanding any sunset provision or representation by a counterparty as to disclosure in a confidentiality agreement, it may have an independent duty to ensure that initially nonpublic information in its possession actually has become public prior to trading.

b. *Trading Walls*

Another way to avoid the misuse of information is for the investor to employ some form of internal trading wall. Members of an official committee in bankruptcy owe fiduciary duties to those they represent, such that the SEC has argued that "[i]n the bankruptcy context, the members of an official committee are properly viewed as 'temporary insiders' of the debtor"[638] and are therefore subject to the same insider trading restrictions as true insiders such as corporate directors."[639] Given the size and diversity of trading activities that occur in many institutions, prospective committee members who have wanted to trade have requested that bankruptcy courts preapprove trading walls and other trading guidelines so as to attempt to immunize them from violating their fiduciary duties as committee members when their employer trades in a debtor's claims and interests.[640]

"Trading walls" (or "ethical walls") consist of policies and procedures implemented within a firm to isolate trading from other activities. Such barriers are one potential solution to the misuse of information and have been approved in

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[638] Mem. of the SEC in Support of Mot. of Fid. Mgmt. & Research Co., *In re Federated Dep't Stores, Inc.*, 1991 WL 79143 (Bankr. S.D. Ohio Mar. 7, 1991) (No. 1-90-00130), 1991 WL 11688857, at *5 (supporting a motion by Fidelity Management & Research Company, a member of the Official Bondholders' Committee, in its request for an order permitting it to trade in the debtors' securities subject to effective implementation of a trading wall).

[639] *Id.*

[640] Since the concept of trading walls gained currency in *In re Federated Dep't Stores, Inc.*, 1991 WL 79143, numerous bankruptcy courts have issued orders allowing committee members to trade in the debtor's securities, provided that adequate information-blocking procedures are established. *See, e.g.*, *In re Calpine Corp.*, No. 05-60200 (BRL) (S.D.N.Y. Jan. 25, 2006), ECF No. 606; *In re Delta Air Lines, Inc.*, No. 05-17923 (ASH) (S.D.N.Y. Jan. 13, 2006), ECF No. 1858; *In re Fibermark, Inc.*, No. 04-10463 (Bankr. D. Vt. Oct. 19, 2004), ECF No. 684; *In re Pac. Gas & Elec. Co.*, No. 01-30923 (DM) (Bankr. N.D. Cal. June 26, 2001), ECF No. 1133; *In re Integrated Health Servs., Inc.*, No. 00-389 (MFW) (Bankr. D. Del. May 4, 2000), ECF No. 1136. Occasionally, a court will refrain from granting this relief. *See, e.g.*, *In re Spiegel*, 292 B.R. 748, 749 (Bankr. S.D.N.Y. 2003).

a number of bankruptcy cases. However, a trading wall may not always provide robust protection.

Typically, an order approving a trading wall will require that the following information-blocking procedures, among others, be implemented:

- a committee member must cause all of its personnel engaged in committee-related activities to execute a letter acknowledging that they may receive nonpublic information, and that they are aware of the order and the procedures in effect with respect to the debtor's securities;

- committee personnel may not share nonpublic committee information with other employees (except auditors and legal personnel for the purpose of rendering advice and who will not share such nonpublic committee information with other employees);

- committee personnel must keep nonpublic information that is generated from committee activities in files inaccessible to other employees;

- committee personnel must not receive information regarding trades related to a debtor in advance of such trades; and

- compliance department personnel must review, from time to time as necessary, trades made by non-committee personnel and the trading wall procedures to ensure compliance with the order, and keep and maintain records of such review.

Similarly, SEC Rule 10b5-1(c)(2) permits an organization that is in possession of nonpublic information to continue trading, so long as the person authorizing the trade does not have access to the information and the organization has implemented reasonable policies and controls to prevent that person from trading on the basis of material nonpublic information. A committee member should be mindful, however, that, regardless of bankruptcy court approval of a trading wall, a committee member should comply with SEC Rule 10b-5.

c. *"Big Boy" Letters*

If a prospective trader of bank debt possesses nonpublic information, it may consider entering into a letter agreement with its counterparty, known as a "big boy" letter (or including the operative "big boy" language in its trade

documentation). In a big boy letter, the counterparty acknowledges the following: (1) it is a sophisticated market actor; (2) the insider may possess material nonpublic information; (3) it will not sue the insider in connection with the insider's alleged use of material nonpublic information in the transaction; and (4) it is relying only on its own research and analysis in entering the transaction.

There is sparse case law addressing the efficacy of this type of agreement between private parties. Particularly in view of the general law disfavoring any advance waiver of fraud claims, the effectiveness of big boy letters in shielding insiders from liability cannot be assured. However, many standard-form bank debt trading documents contain such big boy language.[641]

At least in the context of "securities" (but not in the context of standard-form bank debt trading documentation), transactions involving big boy letters have been the subject of significant investigation by the SEC. Particularly in situations involving "securities," participants should consider whether use of a big boy letter could raise concerns regarding potential information abuse. There may be additional steps that can be taken in advance of prospective trades in order to enhance the likelihood that the trade will pass muster if scrutinized by the SEC. This is a case-by-case, fact-specific analysis, affected by the nature of the trade, the type of nonpublic information involved, the source of the information and the conditions under which it was obtained, and the relative positions and sophistication of the trading partners. If handled properly, these letters continue to serve a useful purpose in some transactions.

(i) Are Big Boy Letters Effective Defenses to Common Law Fraud Actions?

Big boy letters may help shield insider purchasers and sellers from liability to their counterparties for common law fraud. The cause of action for common law fraud generally consists of the following elements: (1) misrepresentation or concealment of a material fact; (2) scienter; (3) justifiable reliance by the other party; and (4) resulting injury.[642] An acknowledgement by a sophisticated party

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[641] *See, e.g.*, THE LOAN SYNDICATIONS AND TRADING ASS'N, INC., STANDARD TERMS AND CONDITIONS FOR DISTRESSED TRADE CONFIRMATIONS § 20 (Apr. 24, 2014).

[642] *See, e.g.*, *Banque Arabe et Internationale D'Investissement* v. *Md. Nat'l Bank*, 57 F.3d 146, 153 (2d Cir. 1995); *Zanett Lombardier, Ltd.* v. *Maslow*, 815 N.Y.S.2d 547, 547 (N.Y. App. Div. 2006). In the case of a claim of fraudulent concealment, plaintiff also must prove that defendant owed a duty to disclose to the plaintiff. *See Banque Arabe*, 57 F.3d at 153.

that it is not relying on the insider-seller for information makes it more difficult to sustain a contention of justifiable reliance by that party.[643] Judicial analysis of "big boy" non-reliance agreements may be context dependent, however, with courts more likely to approve of agreements that indicate a greater level of specificity and pre-agreement exchange of information.[644]

(ii) Are Big Boy Letters Effective Defenses to Private Insider Trading Actions?

Section 29(a) of the Exchange Act states that "[a]ny condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder . . . shall be void."[645] Courts interpret section 29(a) as prohibiting parties from contracting around or waiving compliance with substantive obligations of the Exchange Act, including the duties imposed by SEC Rule 10b-5.[646] To the extent that big boy letters are viewed as purporting to waive SEC Rule 10b-5's anti-fraud requirements, they may run afoul of section 29(a). Indeed, the First and Third Circuit Courts of Appeal have held that big boy and non-reliance letters cannot, consistent with section 29(a), bar private securities actions as a matter of law, even if "the existence of [a] non-reliance clause [is] one of the circumstances to be taken into account in determining whether the plaintiff's reliance was reasonable."[647] However, the

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[643] *See, e.g.*, *Pharos Capital Partners* v. *Deloitte & Touche*, 535 F. App'x 522 (6th Cir. 2013) (holding that a sophisticated investor could not have justifiably relied on a placement agent due to the existence of an agreement expressly disclaiming reliance on any statement by the placement agent, and the possession by the investor of substantial adverse information related to the issuer); *Bank of the W.* v. *Valley Nat'l Bank of Ariz.*, 41 F.3d 471, 477-78 (9th Cir. 1994) (holding participating bank's reliance is unjustified where loan participation agreement contained liability waiver and non-reliance provisions similar to those contained in a big boy letter); *Valassis Commc'ns, Inc.* v. *Weimer*, 758 N.Y.S.2d 311, 312 (N.Y. App. Div. 2003) (holding that, under New York law, reliance is unjustified where a sophisticated contract party expressly disclaims reliance on the extra-contractual representations of its counterparty and fails to verify the accuracy of information in its possession).

[644] *See, e.g.*, *Lazard Frères & Co.* v. *Protective Life Ins. Co.*, 108 F.3d 1531, 1542-43 (2d Cir. 1997).

[645] *See* 15 U.S.C. § 78cc(a).

[646] *See, e.g.*, *AES Corp.* v. *Dow Chem. Co.*, 325 F.3d 174, 179-80 (3d Cir. 2003).

[647] *Id.* at 183; *see also Rogen* v. *Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966).

Second Circuit Court of Appeals has upheld non-reliance agreements against challenges under section 29(a).[648]

Even if a big boy letter cannot bar a 10b-5 claim, the letter still may help undermine the factual basis of a private securities fraud action, which requires proof of elements that generally are the same as those required for a common law fraud claim.[649] As in the common law fraud context, given the representations made in the big boy letter, a party may find it difficult to prove that it actually relied on its counterparty's omissions or that any such reliance was justifiable.[650]

(iii) Are Big Boy Letters Effective Defenses to SEC Enforcement Actions?

Big boy letters may *not* be a defense to insider trading actions brought by the SEC.[651] Unlike a private litigant, the SEC is not required to prove reliance or loss causation to sustain a charge of securities fraud.[652] In addition, trading by the insider may be a breach of a duty of confidentiality owed to the issuer or the other source of the information, and the SEC may charge insider trading solely on that basis.

In one SEC civil action filed in the Southern District of New York, *SEC* v. *Barclays Bank PLC and Steven J. Landzberg*, the SEC alleged that the defendants committed insider trading when they purchased and sold bonds while aware of material nonpublic information acquired by serving on six creditors'

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[648] *See Emergent Capital Inv. Mgmt., LLC* v. *Stonepath Grp., Inc.*, 343 F.3d 189, 195-96 (2d Cir. 2003); *Harsco Corp.* v. *Segui*, 91 F.3d 337, 342-44 (2d Cir. 1996).

[649] *Compare Paracor Fin., Inc.* v. *Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1157 (9th Cir. 1996) (detailing the elements for securities fraud actions), *with Banque Arabe*, 57 F.3d at 153 (detailing the elements for common law fraud actions).

[650] *See, e.g.*, *Emergent Capital*, 343 F.3d at 195-96; *Paracor Fin.*, 96 F.3d at 1159; *Harsco*, 91 F.3d at 342-44.

[651] *See* Rachel McTague, *"Big Boy" Letter Not a Defense to SEC Insider Trading Charge, Official Says*, 39 SEC. REG. & L. REP. 1832, 1832 (Dec. 3, 2007) (quoting statement by associate director in the SEC's Enforcement Division that big boy letters are no defense to SEC charges of insider trading).

[652] *See SEC* v. *Pirate Inv'r LLC*, 580 F.3d 233, 239 & n.10 (4th Cir. 2009); *SEC* v. *Rana Research, Inc.*, 8 F.3d 1358, 1364 (9th Cir. 1993) (collecting authority).

committees.[653] The fact that Barclays and some of its bond trading counterparts had executed big boy letters did not stop the SEC from investigating the defendants' actions or bringing an enforcement action ultimately resulting in a monetary settlement and injunction against the individual defendant's participation on any creditors' committees.[654] This case also illustrates a broader point: Careful attention must be paid to managing legal and reputational risk when using potentially nonpublic information to trade debt.

(iv) Potential Problems Arising from Downstream Transfers

Even if a big boy letter were to insulate a seller from a common law or federal securities fraud claim brought by a purchaser counterparty, future purchasers of the debt instrument—who were not parties to the initial big boy letter—may attempt to bring fraud claims against the original seller or against the original counterparty to the big boy letter. For example, a downstream purchaser may argue that it has a viable action for fraud because it purchased the instrument without entering into a big boy agreement and without the benefit of the material nonpublic information possessed by the upstream seller. In a case in the Southern District of New York, *R^2Investments LDC* v. *Salomon Smith Barney, Inc.*,[655] a downstream purchaser acquired notes from the original big boy purchaser on the same day that the original purchaser had acquired the notes from the big boy seller. Because standard practice for a broker or trading desk is to engage in back-to-back trades, this immediate resale situation, where the broker counterparty to the big boy letter is only an intermediary, is not uncommon. The original purchaser-reseller did not inform the downstream plaintiff that the original parties had entered into a big boy letter or that the original seller possessed material nonpublic information concerning the notes. The notes declined in value after the issuer disclosed its financial difficulties, and the downstream plaintiff brought federal securities and state law claims against the original big boy parties. The district court denied the defendants' motion for summary judgment,[656] and the parties settled for an undisclosed amount on the

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[653] *See SEC* v. *Barclays Bank PLC and Steven J. Landzberg*, 07-CV-04427, S.E.C. Release No. 20132, 2007 WL 1559227 (S.D.N.Y. May 30, 2007).

[654] *See id.*

[655] 2005 WL 6194614 (S.D.N.Y. Jan. 13, 2005).

[656] *Id.*

first day of trial. Because of this type of risk, it may be prudent for a seller to require a purchaser to use a big boy provision in its second-step trade in any transaction that is likely to be viewed as integrated in this way if challenged.

d. *Comfort Orders and Cleansing Disclosures*

In the wake of concerns over potential insider trading liability amid a desire to continue trading securities of bankrupt companies, investors in several recent bankruptcies have demanded "comfort orders" as a condition to their participation in confidential settlement discussions. These orders, entered in the bankruptcies of Residential Capital, LLC and Vitro, S.A.B., for instance, generally provide that investors participating in settlement talks will not be deemed insiders of the debtor by virtue of their participation.[657] They further stipulate that to the extent participants receive material nonpublic information, this information must be publicly disclosed by the debtor within a prescribed time period. As a consequence, participants can obtain a measure of "comfort" that if they trade in securities of the debtor, they will not be exposed to insider trading liability.

An alternative to comfort orders for creditors who wish to participate in settlement negotiations without foregoing the ability to trade is to sign confidentiality agreements designed to restrict trading, but only for a specified period. Pursuant to such agreements, upon the conclusion of the specified period, the company will make a "cleansing" disclosure of agreed-upon nonpublic information, which may include detailed information about the parties' bids and asks regarding matters as to which no settlement has yet been reached. The extent and nature of the company's cleansing disclosure are often heavily negotiated at the outset as creditors, wary of insider trading liability, will often want the company to disclose as much as possible, while the company, wary of revealing too much to investors or competitors, may want to limit its public disclosures.

While neither comfort orders nor cleansing disclosures necessarily prevent regulators from pursuing claims against investors that have participated in settlement discussions, they have both been generally effective in bringing key constituents to the negotiating table. However, their limitations also should be noted, as in some instances parties may be reticent to make proposals or may craft their proposals with an expectation that their proposals may be disclosed publicly,

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[657] *See* Order in Aid of Mediation and Settlement, *In re Residential Capital, LLC*, No. 12-12020 (Bankr. S.D.N.Y. July 26, 2013), ECF No. 4379; Order in Aid of Settlement Discussions, *In re Vitro, S.A.B. de C.V.*, No. 11-33335 (Bankr. N.D. Tex. Jan. 26, 2012), ECF No. 311.

especially in instances where achieving a deal looks unlikely by the end of a period in which parties are restricted from trading.

4. Risk of Vote Designation

Perhaps the most paradoxical source of risk for a prospective acquiror is that its very reason for acquiring claims—*i.e.*, to obtain a controlling position in the reorganized debtor—has been considered by some courts (including the Second Circuit Court of Appeals, which oversees chapter 11 cases in New York) to be a basis for depriving a purchaser of its right to have its vote on a chapter 11 plan counted.

Section 1126(e) of the Bankruptcy Code allows the court to "designate"—*i.e.*, not count—the vote of any creditor whose vote is not cast in "good faith."[658] Based on that provision, a party that purchases claims with the intent of taking control of the debtor might face an allegation that its vote on the debtor's plan ought to be set aside.

a. *Factual Inquiry into What Constitutes "Bad Faith"*

There is no definition of "good faith" or "bad faith" in the Bankruptcy Code. One line of cases has defined "bad faith" as using "obstructive" tactics to gain an advantage. The U.S. Supreme Court, for example, has stated that the good faith requirement imposed under the former Bankruptcy Act was intended "to prevent creditors from participating who by the use of obstructive tactics and hold-up techniques exact for themselves undue advantages . . . ."[659] Other cases have held that a creditor acts in bad faith when it acts with an "ulterior motive."[660]

Although the "good faith" language in the statute is indeterminate, there is little doubt that a creditor is entitled to pursue its self-interest as a creditor, *i.e.*, to increase recovery on its claims, without being subject to vote designation. As the Ninth Circuit has held:

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[658] *See* 11 U.S.C. § 1126(e) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of this title.").

[659] *See Young* v. *Higbee Co.*, 324 U.S. 204, 213 n.10 (1945) (internal quotation omitted).

[660] *See, e.g.*, *In re DBSD N. Am., Inc.*, 634 F.3d 79, 102 (2d Cir. 2011); *In re Figter Ltd.*, 118 F.3d 635, 639 (9th Cir. 1997); *In re 255 Park Plaza Assocs. Ltd. P'ship*, 100 F.3d 1214, 1219 (6th Cir. 1996); *In re Fed. Support Co.*, 859 F.2d 17, 19 (4th Cir. 1988).

> 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.[661]

In applying section 1126(e) of the Bankruptcy Code, courts have eschewed clear rules in favor of a case-by-case approach.[662] One bankruptcy court in the Southern District of New York reviewed the relevant case law and outlined a list of "badges" of bad faith. Such badges include "creditor votes designed to (1) assume control of the debtor; (2) put the debtor out of business or otherwise gain a competitive advantage; (3) destroy the debtor out of pure malice or (4) obtain benefits available under a private agreement with a third party that depends on the debtor's failure to reorganize."[663] Applying these badges, in *In re DBSD North America, Inc.*, a later case that was upheld on appeal, the same court found that acquiring claims as a strategic investor, as opposed to as a traditional creditor seeking to maximize recovery on its claims, was sufficient under the circumstances of that case to evince a lack of good faith meriting vote designation.[664]

b. *Purchases of Claims with the Purpose of Acquiring Control*

In a well-known case, *In re Allegheny International, Inc.*, Japonica Partners, an investor, bought certain of the debtor's subordinated notes after the debtor had

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[661] *In re Figter*, 118 F.3d at 639; *see also In re Fagerdala USA-Lompoc, Inc.*, 891 F.3d 848, 855 (9th Cir. 2018) ("[d]oing something allowed by the Bankruptcy Code and case law, without evidence of ulterior motive, cannot be bad faith" in the context of vote-designation analysis); *In re GSC, Inc.*, 453 B.R. 132, 158-62 (Bankr. S.D.N.Y. 2011) (designation of the votes of a creditor is improper where such creditor can articulate valid business reasons for rejecting a plan, even if such rejection may facilitate allocation of estate assets to such creditor beyond the amount to which such creditor would otherwise be entitled).

[662] *See, e.g.*, *Figter*, 118 F.3d at 639 ("[T]he concept of good faith is a fluid one, and no single factor can be said to inexorably demand an ultimate result, nor must a single set of factors be considered. It is always necessary to keep in mind the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest.").

[663] *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).

[664] 421 B.R. 133 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y. Mar. 24, 2010), *aff'd in pertinent part and rev'd in part*, 634 F.3d 79 (2d Cir. 2011).

proposed a plan of reorganization.[665] After proposing its own plan, Japonica proceeded to purchase a blocking position in a class of unsecured claims as well as in a class of secured bank debt, in some instances at highly inflated prices. The bankruptcy court concluded that Japonica had accumulated its claims in bad faith, noting the following facts:

- Japonica's stated purpose was to take control of the debtor;
- Japonica amassed its position only after it had proposed a competing chapter 11 plan;
- Japonica purchased claims at highly inflated values solely to acquire a blocking position in certain classes;
- in its capacity as a plan proponent, Japonica was a fiduciary of the debtor and had received nonpublic information; and
- Japonica acquired large positions in classes that had directly conflicting interests in pending litigation.[666]

The bankruptcy court concluded that Japonica had acted in bad faith and designated its votes under section 1126(e), noting that its purpose was to take control of the debtor rather than recover the value of its claims, and citing as evidence that it had amassed its position only after the debtor had proposed a plan and had purchased claims at highly inflated prices. It seems clear that the court considered Japonica a "bad actor" that had exploited its position as a fiduciary. It is less clear, however, whether the court considered Japonica's purchase of claims for the purpose of taking control of the debtor as a sufficient basis for designating Japonica's votes.

For a time, the *Allegheny* decision stood as somewhat of an outlier, but in *DISH Network Corp.* v. *DBSD North America, Inc. (In re DBSD North America, Inc.)*,[667] the Court of Appeals for the Second Circuit affirmed lower court rulings that had relied principally on *Allegheny* in holding that acquiring claims "to

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[665] 118 B.R. 282 (Bankr. W.D. Pa. 1990).

[666] *See generally* Scott K. Charles, *Trading Claims in Chapter 11 Cases: Legal Issues Confronting the Postpetition Investor*, 1991 ANN. SURV. AM. L. 261, 303-04 (1991).

[667] 634 F.3d 79 (2d Cir. 2011).

establish control over [a] strategic asset" constituted bad faith.[668] *DBSD* concerned the actions of DISH Network, a satellite television provider and a competitor of the debtors. After the debtors filed their plan and disclosure statement, DISH purchased all of the first lien debt of the debtors at par. DISH then opposed DBSD's chapter 11 plan, and separately offered to enter into a strategic transaction with DBSD. The bankruptcy court designated DISH's vote to reject the debtors' plan as "not in good faith," and the Court of Appeals both affirmed this ruling and further held that the designation of the vote of the sole entity in the class of first lien creditors eliminated the need for the plan to satisfy the cramdown test for that class.[669]

In affirming the bankruptcy court's decision that DISH acted in bad faith, the Court of Appeals reasoned that DISH was a competitor of DBSD that had "bought a blocking position in (and in fact the entirety of) a class of claims, after a plan had been proposed, with the intention not to maximize its return on the debt" but to "vot[e] against any plan that did not give it a strategic interest in the reorganized company."[670] The Court was particularly troubled by the timing of the purchases, which were made after the debtor's filing of a plan, and the evidence that DISH's purpose was to thwart any plan that did not meet its acquisition goal, reflected in internal DISH communications stating that its purpose was "'to obtain a blocking position' and 'control the bankruptcy process for this potentially strategic asset.'" While the Court stated that vote designation is a fact-specific remedy to be employed "sparingly," and relied on lower court findings of extremely late and disruptive conduct by DISH, any prospective acquiror of claims for the purpose of effectuating a transaction for the debtor or its

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[668] *In re DBSD*, 421 B.R. at 137.

[669] 634 F.3d at 101-05.

[670] *Id.* at 79, 104. Other cases similarly have stated that acts by a creditor that are divorced from its motivation to protect or maximize its rights as a creditor constitute bad faith. *See In re Waterville Valley Town Square Assocs., Ltd. P'ship*, 208 B.R. 90, 95 (Bankr. D.N.H. 1997) ("A problem arises when a creditor purchases claims in a manner that advances a *noncreditor* interest, *e.g.*, to gain control of the debtor's operation."); *In re Holly Knoll P'ship*, 167 B.R. 381, 389 (Bankr. E.D. Pa. 1994) (creditor's purchase of claims was in bad faith because motivated by desire to become general partner of debtor); *In re Landing Assocs., Ltd.*, 157 B.R. 791, 807-08 (Bankr. W.D. Tex. 1993) ("[W]hen 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, section 1126(e) is rightly invoked."); *cf. In re Fagerdala USA-Lompoc, Inc.*, 891 F.3d 848, 855 (9th Cir. 2018) (emphasizing that acts intended to protect the creditor's interest in existing claims do not, by themselves, constitute bad faith).

assets needs to consider the decision carefully. It is possible that *DBSD* will ultimately be restricted to claims purchasers who are also competitors of the debtor, but no such restriction has as yet clearly developed.

A subsequent case decided by a New York bankruptcy court provides some guidance on the application of *DBSD*. In *In re LightSquared*, the court distinguished *DBSD* in declining to designate the vote of SPSO, a special purpose entity formed by DISH chairman Charles Ergen to purchase LightSquared debt.[671] LightSquared had sought to designate SPSO's vote based on a host of alleged misconduct, including SPSO's purchase of the debt notwithstanding the credit agreement's prohibition on assignment to DISH, and DISH's withdrawal of a $2.2 billion cash bid for LightSquared's assets, all of which LightSquared alleged was part of DISH's strategy to gain control of the bankruptcy and obtain LightSquared's spectrum assets as cheaply as possible. However, the court declined to designate SPSO's vote, reasoning that, unlike in *DBSD*, SPSO had purchased its claims before any plan was filed. Moreover, although SPSO may have been acting in part based on ulterior motives, its decision to reject the plan—which proposed to replace SPSO's first lien debt with a seven-year, third-lien note that the court concluded was of speculative value—was consistent with the action of an economically self-interested creditor. According to the court, "vote designation should not be ordered where a creditor can articulate a valid business reason for rejecting a plan even if such rejection may also be consistent with such creditor's non-creditor interests."[672] In a separate opinion, however, the court ruled that SPSO's conduct violated the implied covenant of good faith and fair dealing and that a portion of its claim (in an amount to be determined) would be subordinated.[673]

c. *Other Motivations for Purchasing Claims that Have Been Found to Be "Bad Faith"*

Unsurprisingly, courts have found voting with the intent to "put the debtor out of business or otherwise gain a competitive advantage" or acting out of malice or to "obtain benefits available under a private agreement with a third party which

[671] 513 B.R. 56, 89-92 (Bankr. S.D.N.Y. 2014).

[672] *Id.* at 92.

[673] *See In re LightSquared Inc.*, 511 B.R. 253 (Bankr. S.D.N.Y. 2014).

depends on the debtor's failure to reorganize" to constitute bad faith.[674] Moreover, some courts have suggested in other contexts that a creditor who interferes with litigation brought by the debtor or trustee and in which such creditor is a defendant may be acting in bad faith.[675]

d. *Purchases of Claims for Permissible Purposes*

Where creditors can draw a connection between their conduct in a case and their self-interest *as a creditor*, it is unlikely that their votes will be designated, even if they end up controlling the debtor or its property.[676]

(i) Holding Claims in Multiple Classes Is Not Bad Faith

Courts have found that buying and holding claims in multiple classes is not evidence of bad faith. For instance, in *Adelphia*, it was argued that votes by certain creditors in favor of the plan should be designated because they were driven by an ulterior motive—to maximize their recovery in another class.[677] The court found no cognizable claim of bad faith, stating that the creditor's motive

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[674] *See In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995) (collecting cases).

[675] *Cf. In re Keyworth*, 47 B.R. 966, 971-72 (D. Colo. 1985) (denying creditor standing to object to the treatment of proceeds of debtor's cause of action against such creditor on the equitable ground that the creditor had acted in bad faith by purchasing its claim for the purpose of interfering with the assertion of the cause of action); *In re Kuhns*, 101 B.R. 243, 247 (Bankr. D. Mont. 1989) (rejecting proposed settlement of claims asserted by a debtor against a party who had purchased offsetting claims against the debtor, which were also to be settled, with funds provided by the debtor's wife). *But see In re Lehigh Valley Prof'l Sports Clubs, Inc.*, 2001 WL 1188246, at *6 (Bankr. E.D. Pa. Sept. 7, 2001) ("The fact that [the creditor] voted against a plan because its centerpiece was a suit against it without more is not a basis to find bad faith. A creditor is expected to act in its own self interest."); *In re A.D.W., Inc.*, 90 B.R. 645, 651 (Bankr. D.N.J. 1988) ("The existence of the district court litigation involving [the creditor], the debtor and the debtor's principals does not constitute grounds to designate the vote of [the creditor] as not in good faith. The plan, if approved, would leave the pending litigation undisturbed.").

[676] *See In re Three Flint Hill Ltd. P'ship*, 213 B.R. 292, 301 (D. Md. 1997) (creditor did not act in bad faith by buying claims in order to block a plan of reorganization and force the debtor to liquidate; creditor's desire to buy the debtor's property was consistent with a desire to "maximize the amount recovered from the defaulted loan").

[677] *See In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 63 (Bankr. S.D.N.Y. 2006).

was "to maximize an economic recovery, or to hedge, by owning bonds of multiple debtors in a single multi-debtor chapter 11 case."[678]

(ii) Purchasing Claims to Block a Plan Is Not Necessarily Evidence of Bad Faith

Outside of the Second Circuit, numerous courts have held that the purchase of claims to obtain a blocking position in connection with a plan of reorganization, absent some other evidence of an ulterior motive, does not amount to bad faith warranting the designation of votes.[679]

In *Figter*, the Court of Appeals for the Ninth Circuit examined whether a claims purchaser who acquires claims to obtain a blocking position acts in bad faith for purposes of section 1126(e) of the Bankruptcy Code.[680] A secured creditor, Teachers Insurance and Annuity Association of America, which opposed the debtor's proposed plan, purchased 21 of the 34 unsecured claims against the debtor. Because that purchase precluded a cramdown under section 1129(b) of the Bankruptcy Code due to the lack of a consenting impaired class, the debtor sought to have Teachers' votes designated under section 1126(e). The Ninth Circuit affirmed the bankruptcy court's denial of the debtor's motion, reasoning that "'[a]s long as a creditor acts to preserve what he reasonably perceives as his fair share of the debtor's estate, bad faith will not be attributed to his purchase of claims to control a class vote.'"[681]

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[678] *Id.*; *see also In re Pleasant Hill Partners, L.P.*, 163 B.R. 388, 395 (Bankr. N.D. Ga. 1994) (purchasing claims to control the vote in one class for the benefit of another is not an ulterior motive evidencing bad faith).

[679] *See, e.g.*, *In re 255 Park Plaza Assocs. Ltd. P'ship*, 100 F.3d 1214, 1219 (6th Cir. 1996); *In re Monticello Realty Invs., LLC*, 526 B.R. 902, 910 (Bankr. M.D. Fla. 2015) (purchasing control of impaired class to block cramdown not bad faith where creditor acted to protect its secured claim); *In re Three Flint Hill Ltd. P'ship*, 213 B.R. at 301; *In re Waterville Valley Town Square Assocs.*, 208 B.R. at 95-96. *But see In re Applegate Prop., Ltd.*, 133 B.R. 827, 836 (Bankr. W.D. Tex. 1991) ("Sanctioning claims acquisition for purposes of blocking an opponent's plan would also ignite a scramble for votes conducted almost entirely outside the Code's carefully developed structure . . . leaving creditors to select not the best plan but the best deal they might be able to individually negotiate.").

[680] *See In re Figter Ltd.*, 118 F.3d 635, 638-40 (9th Cir. 1997).

[681] *Id.* at 639 (quoting *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989)).

5. Risks Under Antitrust Law

Although acquisitions of "bonds, mortgages, deeds of trust, or other obligations which are not voting securities" are exempt from the HSR pre-notification and waiting period requirements,[682] such acquisitions are not immune from antitrust scrutiny. In general, however, mere purchase of debt will not raise antitrust concerns. Rather, there must be some evidence that the creditor-competitor will use its debt position to thwart a debtor's ability to compete as effectively in the relevant market. Concerns may arise, for example, if the creditor-competitor uses its debt holdings to participate in the bankruptcy process with the intent to delay or defeat a debtor's exit from bankruptcy.

In 1987, AMERCO, the parent company of U-Haul, settled alleged violations of section 5 of the Federal Trade Commission Act with the FTC. U-Haul had sued Jartran, a competing provider of rental moving equipment, for false and misleading advertising. Jartran subsequently filed for reorganization under chapter 11, and U-Haul filed a claim as a creditor in the bankruptcy case based on damages arising from Jartran's alleged false and misleading advertising. The FTC alleged that U-Haul engaged in "sham litigation" in the bankruptcy court proceeding, and that U-Haul had "in fact injured competition by jeopardizing and substantially delaying Jartran's emergence as a reorganized company, capable of resuming its role as an effective competitor."[683] Although there is very limited precedent in this area, the *U-Haul* consent order provides notice that the antitrust agencies may challenge perceived abuses of the bankruptcy process by a competitor.

On the other hand, in *Vantico Holdings S.A.* v. *Apollo Management LP*,[684] an Apollo investment fund owned a 79% interest in Resolution Holdings LLC, a competitor of Vantico in the market for epoxy resin products, while another Apollo investment fund acquired a 35% blocking position in the senior bank debt of Vantico. Vantico sought a preliminary injunction preventing Apollo from voting its blocking position against Vantico's proposed voluntary restructuring plan. The District Court for the Southern District of New York denied the injunction, holding that Apollo's purchase of the senior bank debt did not violate

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[682] 15 U.S.C. § 18a(c)(2).

[683] *See In re AMERCO*, 109 F.T.C. 135, at ¶¶ 21-22 (1987) (consent order containing Complaint filed June 24, 1985). *See also* FED. TRADE COMM'N ANN. REP. 55 (1985).

[684] 247 F. Supp. 2d 437 (S.D.N.Y. 2003).

section 7 of the Clayton Act because Apollo had little incentive to harm Vantico's competitive position given its fund's investment in that company. The court held that, absent indicia of anti-competitive behavior, the mere fact that a company's horizontal competitor or its shareholder acquires the company's debt is insufficient to find a violation of section 7.[685]

[685] *Id*. at 455.