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## Corporate Bankruptcy Panel: ABI Commission's Report on the Reform of Chapter 11: Small and Medium Businesses, Sales of Assets, Financing, and Plans

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**CORPORATE BANKRUPTCY PANEL**  
**ABI COMMISSION'S REPORT ON THE REFORM OF**  
**CHAPTER 11: SMALL AND MEDIUM BUSINESSES, SALES OF**  
**ASSETS, FINANCING, AND PLANS**

*Michelle M. Harner (Moderator)\**

*G. Eric Brunstad, Jr.\*\**

*The Honorable Wendy L. Hagenau\*\*\**

*Melissa B. Jacoby\*\*\*\**

**MS. DEPERT:** Good morning, everyone. My name is Chelsea Deppert, and as this year's Executive Symposium Editor, I'd like to welcome all of you to the *Emory Bankruptcy Developments Journal's* (the "EBDJ") Thirteenth Annual Symposium.

Before we begin, I want to take a moment and thank those who have been invaluable to the *Journal's* ongoing success. First, thank you to Dean James Elliott, Professor Charles Shanor, our alumni advisor Keith Shapiro, and our advisory board for their ongoing support. Of course, a very special thanks goes out to Professor Pardo who generously donates his time mentoring our student authors and providing his expertise to the *Journal*.

I'd also like to extend my gratitude to those who helped make today happen. Thank you to Emory's Marketing and Communications team, the Creditors' Rights Section of the Georgia Bar, for their assistance in publicizing this event.

I'd also like to express my appreciation to the *EBDJ* staff members, the *EBDJ's* Editor-in-Chief, Armstead Lewis, and the Assistant Symposium Editor, Katherine Stuart, for their ongoing support throughout the entire planning process. Finally, thank you to Dean Robert Schapiro, Vice Dean Ahdieh, and everyone else who has helped the *Journal* over the years.

At this time, I'd like to invite Dean Ahdieh to the stage to say a few words.

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**DEAN AHDIEH:** Let me join Chelsea in welcoming you all this morning on behalf of the entire faculty as well as Dean Schapiro. If not for the fact that he is out of town on the road, he would be here welcoming you himself. I do want to thank you and welcome you on his behalf.

I also want to thank again a number of the folks that Chelsea already mentioned. The sponsors of the Symposium, we want to thank for their support to the Board of Advisors including a number of the folks that Chelsea mentioned, Dean Elliott, Professor Shanor, and especially Professor Pardo, and the alumni advisor to the *Journal*, Keith Shapiro, who has really been a dear friend to the *Journal* and also a dear friend to the Law School.

I want to thank the students for making this Symposium possible, and really for all the great work that the *Journal* does—particularly to Armie Lewis, the *EBDJ*'s Editor-in-Chief, and to Chelsea Deppert, the *EBDJ*'s Executive Symposium Editor. Thank you for the work you've done.

As I hope is apparent to all of you from the program today and from other things you already know, Emory Law School considers the Bankruptcy program here at the Law School to be one of its most special and important programs, and it considers the *Bankruptcy Developments Journal* to be really the crown jewel of that program. We believe it to be the best, and I understand there can be some controversy over this, but to be the best Law Journal focused on bankruptcy in the country, and the fact that it is a student-edited journal makes that an even more special achievement. We also think it's suggestive of the distinct focus that Emory Law School has on bridging the value of working across the lines of theory and practice. We pride ourselves here at Emory on doing that generally and for bridging that gap between theory and practice generally. But the *Emory Bankruptcy Developments Journal* may manifest that success or that focus more than anything else that we do. That's evident I think in today's wonderful program, both the substance of the program as well as the wonderful panelists that have come together from practice, from the bench, and from academia. But it's also more evident more generally in terms of the work and the engagement that the *Journal* and its students do in terms of engaging bench, bar, and academia very effectively. There's no better way to learn; there's no better setting to learn than in that combined atmosphere of theory and practice, and so I know that all of you will learn a great deal today. We will have a great morning, and I want to welcome you again, and thank you for being here.

**MR. LEWIS:** Hi, everyone. I'd just like to thank you again for coming. First, just before we begin, I would just like to take a moment just to thank our Executive Symposium Editor, Chelsea Deppert, and also Katherine Stuart, the Assistant Symposium, for all of the effort that they have put in to coordinate this event, and all the diligent planning that they've done. So if you don't mind, I'd just like to give them a round of applause for everything.

I probably should introduce myself. I am Armie Lewis, or Armstead Lewis, and I'm the Editor-in-Chief of the *Emory Bankruptcy Developments Journal*. Today, I have the pleasure of introducing our Corporate panel. Today's Corporate panel will discuss the ABI's Commission to Study the Reform of Chapter 11.<sup>1</sup> Specifically the panelists will discuss aspects of the report that deal with asset sales, small and medium businesses, financing and plans. Before we get going, I would like to just give brief introductions for each of our panelists.

First, we have Professor Melissa Jacoby. Professor Jacoby graduated with honors from the University of Pennsylvania Law School. She is the Graham Kenan Professor of Law at the University of North Carolina School of Law, where she is also the Robert M. Zinman ABI Resident Scholar for the Spring of 2016. Professor Jacoby, along with Professor Edward J. Janger,<sup>2</sup> wrote the article that is in your CLE materials, about ice cube bonds, 363 sales and secured creditor entitlement.<sup>3</sup> This is not only a special article because it's in your CLE materials, but it's also an award-winning article that won the American College of Commercial Finance Lawyers Grant Gilmore Award, and also won the University of North Carolina School of Law's Chadbourn Award.

Second, we have Professor G. Eric Brunstad. Professor Brunstad graduated from the University of Michigan Law School and received his J.S.D and LL.M from Yale Law School. Professor Brunstad is a partner at Dechert LLP's, Connecticut office, where his practice is primarily focused on bankruptcy appellate work. Professor Brunstad has argued numerous cases in front of the Supreme Court. I'm not going to list them all for you, but one I think that one that most of us know is the *Stern v. Marshall*,<sup>4</sup> or the Anna Nicole case for some of the *EBDJ* members out there to reference. He is also a widely

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<sup>1</sup> AM. BANKR. INST. COMM'N TO STUDY THE REFORM OF CHAPTER 11 (2014), <https://abiworld.app.box.com/s/vvirvcv5xv83aav14dp4h>.

<sup>2</sup> David M. Barse Professor of Law, Brooklyn Law School.

<sup>3</sup> Melissa B. Jacoby & Edward J. Janger, Ice Cube Bonds: *Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 YALE L.J. 862 (2014).

<sup>4</sup> See 131 S. Ct. 2594 (2011).

published author and is an adjunct professor at Georgetown University's Law Center.

Next, we have the Honorable Wendy L. Hagenau. Judge Hagenau graduated with honors from Duke University Law School. Before taking the bench, Judge Hagenau was a partner at Bryan, Cave, Powell, Goldstein here in Atlanta where she was named a Georgia Super Lawyer in 2007, 2008 and 2009. She was also named to the Georgia Legal Elite in 2005, 2006, 2007 and 2008. As many of you know, Judge Hagenau is a distinguished United States Bankruptcy Judge for the Northern District of Georgia, and importantly, she is on the advisory board of the *Emory Bankruptcy Developments Journal*. We very much appreciate everything that Judge Hagenau means to our *Journal*.

Moderating our panel today is Professor Michelle M. Harner. Professor Harner is a Professor of Law and Director of the Business Law program at University of Maryland's Francis King Carey School of Law where she teaches numerous Business Law courses which include bankruptcy and creditors' rights. Professor Harner was also a Robert M. Zinman ABI resident scholar for the Fall of 2015. Before becoming a professor, Professor Harner was a partner at the Chicago office of the international law firm, Jones Day, where she was part of the business restructuring, insolvency and bankruptcy group there. Professor Harner has served as the Assistant Reporter for the Advisory Committee on the Federal Rules of Bankruptcy Procedure, and most relevant to our discussion today, Professor Harner was the Reporter for the ABI's Commission to Study the Reform of Chapter 11.

Now I'm going to get out of the way and turn everything over to Professor Harner so we can start our panel discussion.

**PROFESSOR HARNER:** Thank you so much. I want to thank the *Journal* for inviting all of us today. This is a really well thought out and interesting program, and so I look forward not only to this panel's discussion but the one to follow.

As Armstead said, we're here on the corporate panel to talk about the ABI Commission's Report which sets forth its findings and recommendations after studying chapter 11 and potential issues and barriers in the chapter 11 process for over three years. When I was approached to be the Reporter for the Commission, I wholeheartedly accepted both the challenge and the opportunity because I am passionate about our federal bankruptcy system. I'm what they call a true believer. But I'm a true believer because I believe that an efficient

and effective bankruptcy system is necessary to keep our economy growing, our people working, and our markets humming. And so it's essential that if there are deficiencies or things we could be doing better, that we really deliberate and think about those particular items and find a better way forward.

The Commission itself originated from a 2009 ABI program thinking about chapter 11. As most of you probably know, chapter 11 is the chapter of the U.S. Bankruptcy Code focused on businesses. Although some individuals can file for chapter 11 as well, the core focus of chapter 11 is reorganizing business entities. And, at this 2009 program hosted by the American Bankruptcy Institute, there was a ground swelling is the only way I can describe it of concern about whether the Bankruptcy Code had become antiquated, that the practice and the financial markets had evolved around the Code and the Code had not kept pace. Indeed, the testimony both at the 2009 program as well as the testimony at the over 17 public hearings held by the Commission during its three-year study evidenced that the complexity of the financial markets, the new financial products offered in the markets, different externalities including just the way U.S. companies now do business, the growth of outsourcing, the change from hard tangible assets to more soft, intangible assets, and how we think about financing and operating those companies simply had outpaced the Bankruptcy Code.

I may just want to stop for a moment and say don't get me wrong; the 1978 Bankruptcy Code is a phenomenal piece of legislation. It truly has worked well for us for over 30 years and it's proved nimble in a number of ways that I'm not sure even the authors of the legislation had contemplated. But I think more and more it's working because of our fantastically talented bankruptcy bar and bench. They're finding ways to make it work, but they're having to work really hard to do that.

So, the Commission wanted to figure out a way to make it easier for our judges and professionals and perhaps most importantly our businesses to use the federal bankruptcy system. The Commission, as I said, three years of study, the Commission itself was comprised of 22 of some of the most talented, experienced and well respected practitioners, judges and academics in the country. They could not do it alone. They had over 150 members of the profession on advisory committees that were charged to study in depth particular areas of chapter 11 practice, and at the end of the day we produced a 400-page report with over 1300 footnotes. So *Journal* members, just think

about proofing that document, 1300 footnotes—talking about the chapter 11 practice and how we might do it better collectively.

One more thing, before we jump into the panel discussion because your three panelists have some really rich insights to offer and I do not want to stand in their way. But I was surprised as I worked through the process: (1) how engaged everyone was, regardless of their particular perspectives and client representations; and (2) how although it wasn't planned, consistent themes emerged throughout the three-year study and in the report itself. First, there are too many barriers to filing chapter 11. Many testified and the evidence showed the process is too expensive, and for many small businesses it's too complex, and we heard testimony that, in my mind, being a student of bankruptcy law, echoed what we heard prior to the 1978 Code. People were running away from bankruptcy. They're doing everything they can right now to stay out of the federal bankruptcy system. That to me and to the Commission was the first and foremost sign that we had to do something. If you're going to have a federal bankruptcy law, let's allow people to use it. So the Commission sought first to reduce barriers.

Second, once you get people into your federal bankruptcy system, the administration of the system has to be efficient. You can't let companies file and die, and too often right now we're seeing companies file and die or file and be sold. So the Commission thought long and hard about the administration of cases, how can we make it more efficient, how can we make it more certain? We identified I can't even tell you how many, over 30, circuit and case law splits on key issues in chapter 11 cases. Business loves certainty. Not knowing how a court will resolve a key issue in your chapter 11 case is anything but certainty, and that leads to gamesmanship, strategic plays by parties in the case, cost and litigation. And I think many of you here could probably attest to the litigation increase in chapter 11 cases in recent years.

So you reduce barriers, you get them in. Once they're in, you get them through quickly, but then you have to help them out. The third thing the Commission looked at and proposed in its study was refining exit strategies. How can we make it easier and more workable for companies to either exit through a traditional plan of reorganization, or as we're going to talk about here today, a sale of all or substantially all of the company's assets.

Finally, the last major theme running throughout the report and throughout the three years of testimony is if there's one space where chapter 11 absolutely does not work, it's in the small and middle market space. We heard time and

time and again from businesses, company representatives, creditor representatives and judges that for small and middle market companies chapter 11 is inefficient, too costly and really a conveyor belt to death for these companies.

So the Commission thought long and hard about what to do for small and medium-sized companies, and that's one of the things we're going to talk about today. In fact, there's a whole section of the report devoted to what the Commission termed SME's, small and medium-sized enterprises.<sup>5</sup> And I think we're going to kick off the panel talking about SME's. And, Judge, would you do the honors of perhaps introducing the subject? And just to forewarn you, we are going to be completely informal and conversational, so if you hear us interrupting each other, don't worry. It was planned, we're not being rude.

**JUDGE HAGENAU:** Thank you. So, how many of you would guess that most of the business bankruptcy cases filed in the United States are filed by small and medium-sized businesses? When you hear about bankruptcy, you usually hear about the mega-cases, but that's not the vast majority of what we deal with on a daily basis.

Why are there so many small and medium-sized bankruptcy cases? Well, first off, there's an awful lot of small and medium-sized businesses in the United States. In 2010, 505,473 new businesses were started, and they employed 2.5 million people. Professor Harner has an article in one of the ABI Journals where she cites some SBA statistics that 99.7% of U.S. employer firms are small and medium-sized enterprises, and over half the working population works for a small business. So first and foremost, there are just a lot of small businesses out there. They may be family-owned, they may be entrepreneurial type ventures and startups, but they're all different kinds.

But why might they fail more often than large businesses? Well, there's a couple of ideas. First is, when a business starts out, it tends to start out small. So when you have a new idea and your business plan doesn't work, that's a small business failing. So that could be one reason. The other is, small businesses tend to have a smaller amount of capital. They tend to be more focused in the area of business. Maybe they're focused on a particular geographic area; maybe they're focused on a particular product or a particular market. So if something happens in one of those, they don't have the flexibility

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<sup>5</sup> See Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, *supra* note 1, at 275–96.

that a national or international company has to sort of refocus their efforts in another way.

Small businesses tend to have fewer staff. That means that every day is sort of a triage of what do we need to deal with? The president of a small business may be selling one day and fixing the computer the next. So you can't always have the luxury of time and money to plan for the eventualities.

The ABI Report states that in 2013 that 74% of the companies that filed bankruptcy had revenue below \$1 million, 74%, and 90% of the filing companies had 50 or fewer employees. So I asked our clerk's office to pull some statistics for the Northern District of Georgia. In 2014 and 2015, these are chapter 11 statistics, so technically they could include some individuals. But 60% of our chapter 11's had assets below \$1 million, and 93% had assets below \$10 million. So, certainly here in our district we track the national norm, and we are very heavily focused on small businesses.

So, how they can reorganize is critical to our country because they employ a lot of people, but it's also critical to our bankruptcy system because this is where we spend most of our time. The small business owners struggle with using the Bankruptcy Code, as Professor Harner mentioned. Why? Well, small businesses in my experience tend to be disorganized, stretched thin, have little capital, have minimal financial records, and rarely have an exit strategy. So none of those things are very conducive to fitting in to the Bankruptcy Code as we have it right now, where we are asking people as a practical matter to fill out forms constantly, generate information, and spend money. So that's one deterrent.

The other is that small businesses tend to be closely held, so it's really important to the owners/managers of these small businesses know what's going to happen to them. This is not like the CEO of Delta saying, how can I deal with the company regardless of what happens to me. When you're the sole proprietor basically of your business or your family business, this is about how you feed your family. This is about your salary and your kids' salaries or your wife's salary, in addition to the employees that you have.

These small businesses may be a dentist's office, they may be a hairdresser, a barber, they may be a flower shop. They may be a small clothing boutique or giftware. In the Northern District of Georgia we also have a fairly high number of churches, nondenominational churches that are small businesses. So they come in all shapes and sizes, but they look a lot different from Delta. The

proprietors of these businesses want to make sure they end up owning the business at the other end; that's their goal.

And then here's another problem. So the Bankruptcy Code is very much built on formality. If you've ever represented a small business, how many times have you actually seen board minutes, shareholder meetings, stock certificates. When a sole proprietor puts money in to make payroll, is there a note? Is there a loan agreement? How's it documented? It's not. So when they get in bankruptcy, all these things trip them up. All of these good intentioned measures that they took trip them up in the form of preferences, fraudulent conveyances, recharacterization of their loan to equity, that sort of thing.

So because of these issues, because of the expense and the inflexibility, many of them are choosing other avenues for their reorganization such as state court receiverships or assignments for the benefit of creditors.

So, the Bankruptcy Code has had a small business section for quite a while. What it provides right now is for a person, which notably includes individuals who have noncontingent, liquidated debt of \$2,490,925.00 or less. That's your small business debtor. So roughly \$2.5 million of noncontingent, liquidated debt. It excludes a person whose primary business activity is owning or operating real estate, and there's no committee appointed under the present scheme for the small business. But the SME, as the ABI has drafted it, is a little bit different. Here, the Commission does not anticipate that individuals would be part of the small business structure. A SME would be any business with \$10 million or less in assets or liabilities. So think about that for just a minute. It's \$10 million as opposed to \$2.5 million. It's assets or liabilities, not just liabilities, and it's all liabilities, not just liquidated, noncontingent liabilities. So, there are some different standards for what makes an SME under the ABI recommendations.

**PROFESSOR HARNER:** And, Judge, if I can just interrupt you there, I'd be interested on your perspective. So, when the Commission was crafting that definition, I know we want to talk about whether that dollar amount is the right bucket to be thinking about. They heard testimony that under the current system that you described so well, there's often a lot of unnecessary uncertainty or litigation about the liability calculation because of the variation that's in the Code as you're thinking about that threshold. Do you see a lot of litigation on that issue? Or how in practicality do small businesses handle that calculation?

**JUDGE HAGENAU:** In my experience, the number is so small, \$2.5 million, that we don't have a lot of litigation over whether you've met it or not. Most of the companies that fit this \$2.5 million truly are largely sole proprietors. It really is the doctor, the dentist, the hairdresser, the shop owner, and there's not a lot of question about the contingent, unliquidated.

**PROFESSOR HARNER:** And do those, when we're talking about the sole proprietors, you can have a true sole proprietor where it's a person doing business without an entity in front of it, so not a corporation, not an LLC or some type of limited liability structure to work from. Some would say that those are just really big chapter 13 cases. Are they just really big chapter 13 cases?

**JUDGE HAGENAU:** In many instances they are approached by the debtor and by counsel as a large chapter 13, because they frequently start by an individual going to a chapter 13 lawyer and saying, here's my problem. And then the lawyer realizes, oh, well, you're not really a sole proprietor; you have this separate business and you really have more to deal with than we can deal with in a chapter 13. But they're really moving together because if the company has debt, more than likely the individual has guaranteed the debt, so they're running the same paths.

**PROFESSOR HARNER:** And that's so helpful. So I'm going to let you continue because you're doing a terrific overview. I just wanted to highlight that I think there's a misperception that small cases mean simple, easy cases.

**JUDGE HAGENAU:** That's not true.

**PROFESSOR HARNER:** I don't think that's true at all. So as we're thinking about where to draw lines and the appropriate structures, the Commission struggled with it, and I think as a profession we need to struggle with it as well.

**JUDGE HAGENAU:** One additional piece of the ABI's recommendation for an SME is that a company with assets or liabilities between \$10 and \$50 million could opt to be treated as an SME, so you can have a company with \$50 million of assets or \$50 million of liabilities that can opt to be treated as a small business. That would be subject to objection by the U.S. Trustee or by a party in interest.

Now, one of the other areas that the ABI recommended change to that I think we will all be applauding is getting rid of the deadlines for small

businesses.<sup>6</sup> Right now the Code requires that a plan be filed within 300 days, and that a plan be confirmed within 45 days of when it's filed. And most of us would agree these deadlines are difficult to meet and difficult to apply. Issues such as what if I amend the plan outside the 300 days? What if I want to file a second plan but it's outside the 300 days? What if I need to continue the confirmation hearing? And I think most of us on the bench side have come up with solutions, but it seems artificial to make people fit within this guideline. So the ABI recommends that the debtor have the same exclusivity period in an SME that they do with regular chapter 11 cases, 120 days, and that at the outset you have something that I think is akin to a Rule 26 conference. Basically, you sit down with the judge and you figure out what the scope is going to be of the chapter 11 and what deadlines will be set in terms of when a plan should be filed.

One of the other provisions of the ABI's recommendations I think is really interesting is they recommend getting rid of the examiner and using instead an estate neutral. The estate neutral would be appointed by the court and then the neutral's duties, the scope of their duties and how long they serve is really just determined by the court. And with respect to the small business area, you could see how that could be really helpful, because the court could appoint somebody with some financial acumen if they felt like that's what a small business debtor needed. They could appoint someone who's more lawyerly and really define what it is that you want that estate neutral to do.

**PROFESSOR BRUNSTAD:** So, Judge, some people would ask the question, is it really worth saving these small businesses? And what I'm hearing you say so far is that, yes, it is. We live in a society in which small businesses are responsible for most of our job growth. Small businesses are huge employers in the economy. But it's kind of frightening. How many of you have ever wanted to start your own small business? Maybe a restaurant or something like that. Raise your hand. Most people sort of have that dream at least somewhere in the back of their mind.

**PROFESSOR JACOBY:** Not necessarily in law school.

**PROFESSOR BRUNSTAD:** Not necessarily in law school, but in business school that's for sure. But yet most small businesses, more than half of them fail within five years, so it's a big problem. But what do we do? There's this neutral idea, but what about the problems that many small businesses actually

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<sup>6</sup> *Id.* at 294–96.

face that can seem to be kind of intractable? So many small businesses are started by people who come into the business really unaware of what they're getting into. They're very optimistic, they have an idea, but they run into all kinds of problems: inventory management problems, growth management problems, labor management problems, product issues, customer service issues, overhead problems, unfamiliarity with financing terms, all of those kinds of things, competitive problems, they don't understand what they're doing when they sign these lease agreements, they don't know what a franchise agreement is, all of these kinds of things. Is there some sort of means in which we can address some of these problems in the context of this estate neutral or something like that in this process?

**JUDGE HAGENAU:** Well, I think the idea is that the estate neutral may be able to assist with some of the education, but I don't think anyone is expecting the estate neutral to be—correct me if I'm wrong—to really be representing the debtor in the sense of giving true legal advice or business advice. It's really more of a sounding board and perhaps pointing you in the right direction of where to get assistance; would that be correct?

**PROFESSOR HARNER:** I think that's absolutely correct, and just by way of background, the estate neutral really serves two different purposes. In the Report, there's the broad concept of the estate neutral that the Commission felt should replace an examiner because although examiners can provide value in certain kinds of cases, it's a very limited role. Presently some of the triggers for the examiner, the mandatory appointment trigger, most commissioners felt wasn't serving a meaningful purpose, and they felt judges were having to try to work around the limitations in thinking about the needs of the particular case. So on whole, the Commission was trying to make the role of an estate neutral more flexible so that judges absolutely could help a particular debtor. And then when you thought about the estate neutral in the small business context, I think in general the Commission felt we were trying to make small businesses pigeonhole themselves into what Congress thought a small business chapter should look like. And what the Commission really wanted to do rather than let a small business debtor come in and have the Court and the parties build a chapter that would work for them. And there I think the estate neutral would play a vital role so that the judge, and I don't know if you've seen instances where you could do this, could say, well, this particular business debtor has a fantastic concept but no idea how to put together a viable business plan. Let's find a turnaround expert that can come in and assist with the business plan and

some of the financing challenges it's facing. So, again, not advising but really helping them from a strategic standpoint fix one of the obstacles in their case.

**PROFESSOR JACOBY:** Could I jump in and ask a question to the Judge or Professor Harner? I have two questions about the estate neutral. One, is that even though there seems to be general agreement that this would be a beneficial addition to the 99% or 95% of cases that are SMEs, and yet the proposal isn't to make them mandatory, I think, in these cases; it is to make it a possibility, which strikes me as perhaps raising a litigation point and some costs associated with that. So I'd be interested in responses, reactions to that.

The second thing, what it really means to be an estate neutral versus a chapter 12 Trustee versus an examiner. We're asking a lot of many of these roles, and they don't hang together in theory all that well. They're sort of a mixture of things we would like these parties to do. So I struggle with, even if there does need to be some new governance structure, because we can't rely on what the 1978 Code sort of expected about a creditors' committee and not a huge lien on everything, I'm a little bit left struggling with how to cabin what the responsibilities are.

**PROFESSOR HARNER:** I'll take a quick crack and then would welcome additional insight. So first, on terms of whether it's mandatory or not, the Commission actually debated whether it should be a mandatory appointment of an estate neutral if a company, an SME files, because I think there's where true utility can be found in the estate neutral role. The concern was twofold: one, we didn't want to create a barrier to a small business wanting to file a chapter 11 case. So, in counseling a business I think the Judge rightly pointed out one question you get is, can I keep my business? Can I keep the equity when I come out of bankruptcy? The other is, well, who runs my business? And we didn't want to create a situation where a mandatory figure in the bankruptcy system could be perceived as displacing management, because again, we wanted to encourage filings, not discourage.

As far as the various roles or theories that could underline a concept like the estate neutral, I think you're right; it's exceptionally broad, and I think that's where the Commission found beauty in it. But the Commission also was mindful that at least for many part of the challenge in chapter 11 right now is the restraint on judicial discretion that has flowed from some of the amendments to the Code over the years. And, so underlying many of these concepts as the estate neutral is a suggestion that we need to have judicial discretion reintroduced into the process because no chapter 11 debtor is similar

to the next. It's not a cookie cutter process. You need an informed bankruptcy judge to help craft a process that works for the company, and so the concept is the order appointing the estate neutral when warranted would specify the role and make sure that it was tailored to the particular issues, and one not mandatory but also not cookie cutter.

**JUDGE HAGENAU:** And I agree. I think a lot of times the small businesses come in with really one problem or another. Maybe they're behind on their taxes, and so then what really needs to happen is some negotiation with the IRS or the Department of Revenue. Maybe they have a problem with a secured lender and really the negotiation just needs to be a restructuring of the debt. In those cases you might not really need an estate neutral.

But then there are other situations where they would, and getting back to Professor Brunstad's original question, I think a lot of folks when they get into this, I don't think we do a lot of education in high school or college about how to run a business unless you happened to have chosen entrepreneurship or something like that as your major in college. The bankruptcy section of the Atlanta Bar does a consumer education program in the high schools, which we've just been doing this month. In the high school that I went to, one of the classes was called a Human Resources class, which I'd never heard of before. It was relatively small, about ten students, but the teacher said these were all students who expected to run their own business and that's why they were taking that class. They asked the best questions. So I think if you had some more opportunities like that, because a lot of people that start businesses do it right out of high school. It doesn't have to be someone who's got a masters in something to go start a business. Education, I think, is a big part of it.

Let me turn before we run out of time to plan confirmation, because that does remain the goal in a chapter 11 of an SME is to confirm a plan, and there are a couple of proposals that are different. You will hear from Eric about proposals that are different across the board to all chapter 11's, and those I may just touch on briefly, but I won't go into any detail.

With respect to the SME, one change is that § 1111(b) no longer would apply. So that means if you are an undersecured creditor, your claim would be bifurcated under § 506 and you would not have the option of deeming your entire claim to be secured.

**PROFESSOR JACOBY:** That sounds like a very popular proposal to many of those who read the Report, right?

**JUDGE HAGENAU:** Not to the secured lenders.

**PROFESSOR HARNER:** It's been a point of discussion.

**PROFESSOR JACOBY:** That was a joke.

**PROFESSOR HARNER:** But interesting, that's really the only place in the SME context that the secured creditors' rights are impacted because they're not part of the equity retention compromise on the absolute priority rule that was proposed.

**JUDGE HAGENAU:** So another change, let's talk about the absolute priority rule. Unfortunately, that is staying under the ABI's recommendations in this small business area. So you can avoid the absolute priority rule of course by getting the acceptance of a class. The ABI recommendations stick with the current Code construct, which requires an affirmative vote to be an acceptance in a plan.<sup>7</sup>

Personally, this is an area I would like to see further exploration at least as to the smallest businesses, and would view it more like a chapter 13 where an absence of an objection means the class has accepted. And I say that because, again, in the smallest cases you tend to have one problem or another, but it rarely is the unsecured creditors. And when you look at who the unsecured creditors are, it's amazing how often it's American Express and Discover. And it's hard to get an accepting vote out of American Express, although I think Ed Danowitz has done it once or twice.<sup>8</sup> We had to extend the confirmation hearing a couple of times to be able to get that vote in. But why are we going through that if no unsecured creditor cares enough in a small business case to vote or to object? My personal opinion is, at least in the smallest cases we should do it more like a chapter 13. But you still have to have the vote. So if the plan has not been accepted by all the classes, now you have to deal with the absolute priority rule. The ABI would actually codify the new value exception, and the exception would be subject to a market test much like the *LaSalle* case.<sup>9</sup>

But there's another new concept that the ABI has recommended, and it is called the equity retention plan. The equity retention plan would be another way that the owners could keep their equity without putting in new value. This

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<sup>7</sup> See *id.* at 296–98.

<sup>8</sup> Edward F. Danowitz, Jr. is an attorney in Atlanta, Georgia that has represented business and business owners with startups, reorganizations, bankruptcies and other related matters.

<sup>9</sup> 526 U.S. 434, 457–58 (1999).

would look like this. So the equity keeps 100% of the voting interest and 15% of the economic interest in the business. The unsecured class that did not vote to accept the plan gets 85% of the economic interest and the right to vote on certain transactions such as a merger or the sale of virtually all the assets. The company would pay the net cash flow to the unsecured creditors at least annually for three years, and in the fourth year the unsecured creditor class would have to be paid in full without interest, as I understand it, and all of the cash flow payments you've made would be credited towards it, so you're just making up the difference in the fourth year. But if you haven't been able to pay the creditors in full by year four, then the unsecured creditors get 85% of the common stock.

So, I understand where this concept is going, but thinking about the small business cases that I see, most of the time are the smallest, I have a hard time seeing how this works practically because most of them while I suppose technically they have stock somewhere, nobody really works with the same sort of corporate structure. There's not really priority stock and common stock, and truthfully there's not a distribution on your economic interest. If you're a small business, the way you get money out of the business is through your salary most often.

**PROFESSOR BRUNSTAD:** What would they do with the stock that they got? They've got a stock in small business enterprise—

**JUDGE HAGENAU:** In the laundry.

**PROFESSOR BRUNSTAD:** —down the road, in the laundry operator, the florist shop, the dentist's office or something like that. The only person or I guess the most interested person would be the debtor in having that back.

**PROFESSOR HARNER:** I feel like I have to jump in to explain the purpose here. So, first I will concede personally as Professor Harner and not speaking for the Commission, that I do think there are a number of ways we could think about dividing the buckets with small businesses and perhaps the very smallest of the small business cases could do something more akin to a chapter 12 type situation or a chapter 13. But then the only other thing we have is what works well for the mega cases, and there seems to be this large area in-between the really, really small business cases and the megas that's this gray area where the Bankruptcy Code is not working—they're not simple corporate structures, they're a little bit more complex. So, I think there's a lot of robust and

constructive dialogue we could have about how to revamp the small business and mid-market provisions.

But on the plan specifically, it's very akin, for those of you who do startup work, to thinking about a venture investment in a small business company. So you're getting a preferred interest basically, and you're setting your maturity or redemption time at four years. And so they have the opportunity, the small business, to repay their creditors which many companies want to do. No one likes to stiff their creditors, particularly if you need them moving forward. And here I'm thinking more about the mid-market companies who need those suppliers and vendors and other small businesses they're working with. And so you give them a preferred interest much like you would give a venture in a startup arrangement that matures at the end of the four years. If you can pay them off then or sooner, you get the benefit of not having to pay interest on that investment. That was one of the balances struck. And if you can't, you're then sharing the ownership of the company, but it really gives a small and particularly a mid-market company a longer period within which to reorganize so that we're not really imposing artificial parameters.

So, that's the concept. Certainly refinements could be made. And just one other note that I probably should've highlighted before we started, the Commission Report was unanimously accepted by all the Commissioners. It's a consensus product, so there are lots of compromises built into the provisions. And as you're sitting here in the audience, whether you're a law student or you're a practitioner or you're a judge or academic, I would like you to think about ways the proposals we're discussing can impact and change the practice day-to-day right now. We would like to see this adopted by Congress at some point, but we've already seen courts adopt particular provisions. I've spoken to practitioners who have found ways to work concepts into their negotiations and gain a little bit more leverage. So, a lot of what we're talking about I think can have immediate impact. But I think the consensus point is important as well because there are particular bargains that may not be what you would want for your particular client, but again, it was the nature of the compromise.

**PROFESSOR BRUNSTAD:** Well, I applaud the creativity. I think this Report is actually a wonderful piece of work, and I think certainly has a lot of suggestions that are definite improvements on the current law. But I guess for consistency, to the extent we're treating these small businesses like sole proprietorships, even though they may have a corporate forum, they really are an extension of the owner typically and the owner's human capital is really

bound up in the business. Shouldn't we be treating the business essentially an extension of human capital, and just like you can't take a lien on human capital and you can't own human capital and only the individual gets to own his or her human capital, shouldn't we treat businesses that way, too, which is again the chapter 13 model? So that we recognize that the equity ownership in the business is really analytically no different than the equity ownership in one's own human capital, in which case it's just something you just get to keep.

**PROFESSOR HARNER:** So, I would venture to say that Professor Jacoby and I probably agree with you on your conceptualization of human capital and whether or not you can take an interest in it, we're aligned there and we both have spoken extensively about it, but I will tell you there are people who vehemently disagree with that. And so I think that's an open issue as to exactly what a business entity is, what value generation is, and what a secured creditor is entitled to a lien in, which relates to this plan concept we're talking about, what you should make or ask an owner to give up in order to keep the business entity itself.

**PROFESSOR JACOBY:** And if one does lean more in favor of Professor Brunstad's framework, then we're in more of a disposable income question and a proportion of disposable income.

**JUDGE HAGENAU:** And then it looks more like a chapter 12 or even an individual chapter 11 where, if someone objects then you have to make sure that your disposable income is paid over a certain period of time. The other thing that's to me nice about the chapter 11 individual concept and chapter 13 concept, chapter 11 individual, is that you wait and see if someone objects. The problem with using § 1129 on a small business is that you're going through this thou shalt not confirm a plan unless, whereas those other frameworks allow you to confirm a plan, and only if someone objects do you have to get to some of these more complex issues. I would love to see it go in that direction.

**PROFESSOR JACOBY:** Even after *Espinosa*?<sup>10</sup>

**PROFESSOR HARNER:** I'm going to keep us moving. Judge, I want to thank you. That was a fantastic overview and gives us a lot of food for thought. I think the real takeaway is on the small business space, small middle market space I should say, I think everyone agrees we need to do something. I think people generally are in robust agreement that they're not working for these types of companies. The question then becomes how we fix the problem, and if

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<sup>10</sup> See 559 U.S. 260 (2010).

it's a one-size-fits-all fix for this group of small middle market companies, or if we need to think more strategically about the kinds of companies, the people behind the companies, and how we best serve those objectives.

So, we've been talking just now about plans and the way to use a plan of reorganization as a company's exit strategy. One of the major shifts I think in chapter 11 practice, particularly over the past, say, 10 to 15 years, has been a new exit strategy, one that's not currently condoned by the U.S. Bankruptcy Code, and that's exiting through a sale of all or substantially all of the company's assets. The Commission was quite struck by the increase in the number of cases that conclude through a sale of all or substantially all of the company's assets. Now that's not to say that companies aren't doing plans. There certainly are plans still being confirmed. But if you look at the data, there is a linear trend to increase § 363 sales, which corresponds to a decrease in the length of chapter 11 cases. Now some would applaud that—they would say, “yay, that reduces costs, it reduces the time a company is a ‘bankrupt’ in a chapter 11 case.” But some would also say, “the depression in time has gone too far.” In fact, the average case, particularly when it's a sale of all or substantially all of the company's assets, is right now between thirty and forty days. That's a really quick chapter 11 case. And even in a simple, “simple” chapter 11 case, I'm not sure how the court, the U.S. Trustee and the creditors who weren't party to the negotiations prior to the filing get their head around the financial situation and the alternatives available to this particular company. So, the speed with which companies are “reorganizing through sales” is a little troubling and the Commission thought about it long and hard. And I'm going to let Professor Jacoby talk about the Commission's proposals and her thoughts on sales of all or substantially all of the company's assets. And again, I just want to emphasize that the developments in the Commission Report were based on the empirical data we saw, the testimony we heard, and then also this new development of structured dismissals. And certainly there's a lot of conversation around structured dismissals currently, particularly with the Third Circuit's decisions in *Jevic*<sup>11</sup> and *ICL*<sup>12</sup> which seem to embrace the concept in at least some cases in some respects. So there's a lot to talk about here, and we have only a limited amount of time so take it away, Professor Jacoby.

**PROFESSOR JACOBY:** I agree with Professor Harner.

**PROFESSOR HARNER:** And Congress should, as well.

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<sup>11</sup> 787 F.3d 173 (3d Cir. 2015), *petition for cert. filed*, No. 15-649 (U.S. Nov. 16, 2015).

<sup>12</sup> 802 F.3d 547 (3d Cir. 2015).

**PROFESSOR JACOBY:** Bankruptcy provides an extraordinary remedy. I think we all can acknowledge that, even if it performs such an important role in our economic growth in society, it is providing extensive powers that are just not available under state law. In the 1978 Code, there was a calibrated balance and governance structure to insure that a business or an individual, but a business who got the benefits of bankruptcy was exposed to a deliberate process with checks and balances, creditor voting, creditor entitlements and rights to speak up in other ways, and the possibility of operational restructuring, managerial changes, financial restructuring. And then we have the problem of what if the business is—ice cube is actually too nice sounding in a way. Think of it more as a truck of rotting salmon. So the truck of rotting salmon comes in and people say, we don't have time for these niceties. Nobody wants this truck of rotting salmon to sit here. We must act today. Who could be against that? And that sounds reasonable. Of course we don't want to subject a depreciating asset that will not only be worth less tomorrow, but affirmatively offensive, because of the niceties that the 1978 Code anticipated.

On the other hand, the system isn't really set up to fully sort those trucks from all the other businesses and sometimes it is not that hard to turn a business that otherwise wouldn't be a depreciating asset into one that is, the idea of unplugging the freezer or refusing to provide financing. So what we have now is a situation where fast sales might be benefitting some stakeholders. But the bankruptcy estate, many of its creditors and other intended beneficiaries of bankruptcy law such as employees, such as communities, are potentially suffering in the process. And part of the problem is that speed obscures the ability to resolve these issues.

Another problem is that sometimes the sale and handing out the money, if there is any money from it, if it's not all credit bid, are lumped together, and that's further obscuring making sure that assets are allocated in anticipation of the way that Congress said so in the 1978 Code.

In this way, I think the Commission Report asked all the right questions that need to be asked about this proliferation of 363 sales that now perhaps parties feel that they would not be serving their clients if they proposed a traditional plan in some cases. So we have to move away from that idea.

And so there are a couple of different tools that the Report talks about. One is a timing point that you're not supposed to do the sale in the first 60 days except if you can show extraordinary circumstances—shifting the presumption somewhat. Now, we already have some of that in the Federal Rules of

Bankruptcy Procedure, but I think this is seeking to heighten that and shifting the leverage around that timing.

**PROFESSOR HARNER:** And if I can just interject here. I think here the general sense of the Commission was that thing called the automatic stay that we used to value so highly in bankruptcy cases had disappeared in many.<sup>13</sup> And so the 60-day moratorium both in the sale context and the financing context which go hand in hand, really was an effort to reinstitute the automatic stay. Let's give that honest but unfortunate debtor an opportunity to catch its financial breath. And so that was a huge part of it, as well as to heighten, as you say, what we already have in the system.

**PROFESSOR JACOBY:** Again, the goal is making sure that the parties who were affected have adequate information. That is part of the bankruptcy bargain. If someone is going to get a Court's judgment and order, ruling assets are sold free and clear of a very wide range of claims and interest, that is a very big deal, and so there is a trade-off to make sure that people have the information.

Second, there's a new § 363(x).<sup>14</sup> What I see here, and I do agree with this, is we're now so far down the path it's hard to put the genie completely back in the bottle, that there is a sense that a sale process rather than a sale through a plan with all the bells and whistles sometimes may well be the best thing to do. But it adds some of those procedural protections or substantive protections for creditors that we find in chapter 11 plan process in § 1129.

Now I would say that one might ask, how did you choose the plan confirmation requirements that you did or that the Commission did because it's not all of them? It's just some of them. I think that it's not all priority debts get certain protection but just some of them. So, I would raise some questions about that. But it seems to me that if you're going to keep some standalone sale process that there has to be more robust protections for creditors and other stakeholders, and so I do think that's exactly right to go down that path. Because otherwise we do have a prepackaged bankruptcy possibility already in the Code, and so if it makes it a little bit harder or by enhancing all creditors rights to object and be involved in the sale process, maybe that will incentivize some debtors and creditors who are particularly involved in the case to say,

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<sup>13</sup> See Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, *supra* note 1, at 79.

<sup>14</sup> *Id.* at 83.

you know what, let's just do the regular plan. Maybe we were onto something there.

**PROFESSOR JACOBY:** And I was just going to say you highlight some important points. So you can do a prepackaged plan, but oftentimes we're not so concerned about the speed in those scenarios because those who might not have been at the bargaining table to negotiate the prepackaged plan aren't being impaired at least in theory. You typically reinstate your trade or you pay them 100%, and where you're compromising the debt through the plan is at the secured in recent times or the bondholder level where you have those parties at the table prior to the filing. And so your emphasis on getting the information to all the parties who are impacted by the bankruptcy case, even if they're going to be wiped out through the process and giving them due process to understand what the company contemplated and why the end result is best for the estate is so critical and actually formed the pieces of § 1129 that the Commission borrowed in the 363(x) context.

**PROFESSOR JACOBY:** So two more pieces, there are actually other—I think there's a lot of connecting pieces in the Commission Report, so that's why it's great to read the whole thing but I'm just going to mention I think two more categories. A third is something that's already very well familiar in all federal court litigation but especially in bankruptcy an administrative claims reserve. It is essential to separate the question of whether you need a fast sale and whether the money has to be handed out yesterday or at latest today. We need time sometimes to sort out entitlements and in particular this is debated at length in the ice cube bonds paper that's in your materials, to make sure that especially when we're dealing with secured claimants, but also with unsecured, that what is being claimed actually is supported by applicable, non-bankruptcy law.<sup>15</sup> That includes the scope of the security interest, whether it was properly perfected, and whether applicable state law would recognize the boundaries of the security interest that's being claimed. And so, sure, we need to sell the truck of salmon today, but we don't necessarily need to hand out the money today. We need to have time to sort that out.

Fourth piece I would mention does relate back to structured dismissals. The idea of yet another exit out of bankruptcy where, at least in the Third Circuit, even over the objection of priority creditors with WARN Act claims or could be any priority creditor, that it's possible to confirm or order a dismissal order that allocates settlement money basically in a way that does not comport with

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<sup>15</sup> See Jacoby & Janger, *supra* note 3.

the priorities in the Bankruptcy Code, whether in § 507, whether in the absolute priority rule in § 1129, or more generally given the origins of the absolute priority rule, the Commission Report says it is not necessary to have a structured dismissal option. Professor Harner will correct me if I don't have that exactly right, if there was a caveat there. And I fully agree with that, that conclusion, there is the *Jevic* decision, there has been a cert petition filed, there is an amicus brief by academics that I was part of supporting the Supreme Court taking that.<sup>16</sup> I don't think we know yet, but I think that is an important piece to respecting creditor entitlements, and that in certain ways if Congress says that certain groups should not be priority creditors anymore, okay. But until then, if you want some of these benefits of bankruptcy, you've got to take the package.

**PROFESSOR BRUNSTAD:** Let me ask you this question in sort of unpacking all of these proposals and looking at it from a little bit higher altitude. What is it that we are doing chapter 11 reorganization for? We seem to have these very competing perspectives, and to a large extent as was explained earlier, this Report represents a compromise, but let's just step back for a second. What are we doing? What is this for? On the one hand, we have the idea, call it the pro-creditor idea, that bankruptcy reorganization is about getting the claims paid and it's about respecting the entitlements of the parties. Certainly there is that aspect to bankruptcy. You can't deny it. But this seems to be like a focus especially on the rights of secured parties. Secured parties have these property interests in the assets; therefore, certain things follow from that. So that's one idea. A second idea, which is in tension with that, of course, is no, what we're really here to do is we're here to salvage this viable business. We're here to try to make sure that this business survives and goes on, that the jobs are saved, the assets are used in this productive way. After all it's very hard to put these businesses together. It's very hard to put together all the capital, the human capital, the physical assets and things like that to create these things. Businesses fail at alarmingly high rates. If we can save them, that's great. That's what we're really here for. Or, is it a combination of the two, recognizing that they conflict? Which do we think is more important between the two? Because if we think that saving the business is really our focus, then shouldn't we be focused on the chapter 11 process as a problem-solving process? We're going to solve the problems of what to do with the labor, what to do with the assets. The grand bargaining theory, we're going to bring everybody in to sit at the table and negotiate the resolution and come up

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<sup>16</sup> 787 F.3d 173 (3d Cir. 2015), *petition for cert. filed*, No. 15-649 (U.S. Nov. 16, 2015).

with, which of course is going to take time. It's the anti-speed idea. So which is it? And where should we draw the line? And depending on how we draw the line, how does that affect our view of these proposals?

**PROFESSOR JACOBY:** Well, I think this is an especially good time to ask those questions, not only because we need to rethink or debate how chapter 11 is working, but at a time when we're seeing governmental units struggling with their own financial distress and reaching for a bankruptcy solution for themselves. And then I might ask back, is there a different theory of bankruptcy for a municipality or indeed a commonwealth such as Puerto Rico than there would be for a private entity? And do we have a spectrum of entities from purely private, which still have public spillover effects, to a true governmental unit, and how we deal with that. So I've broadened, as if the question could be broadened, I have tried to do that, and that is a great time to ask Professor Harner about the theory of what bankruptcy is for that you all were going for.

**PROFESSOR HARNER:** I think that's the million dollar question that has plagued bankruptcy scholars for eons. This is not a new question and I would give you what I tell my students is the lawyer's answer: It depends really here who you ask. And I think when the Commission thought about this issue because it did, the first thing it did as a body was step back and say, let's think about policy and why we're doing what we're doing, and I think they chose the middle road or, Professor Brunstad, what you described as that let's try to serve both purposes, let's try to reorganize companies while still respecting state entitlements and trying to maximize value for creditors. That's the dual purposes of the '78 Code we hear referenced all the time. Because it was trying to balance those competing policy concerns, you see some of the compromises struck in the Report that we've already discussed and some we won't get to today. I think on balance there was a preference for saving businesses where there was a direct conflict, but being mindful that you do have the state law entitlement and maximization of value principle at play. That being said, as we think about reform moving forward, I think the policy question drives the legislation. And in an environment where we're trying to figure out how to save jobs, where we're trying to figure out how to grow our economy, how to compete with other countries who seem to be doing entrepreneurship much better than we do, it may be time to rethink the policy question and what Congress sees as an efficient and effective bankruptcy system because I think if you answer the question it's primarily to save jobs and reorganize

companies, you get a much different reform package than if you compromise or you go the other way.

**JUDGE HAGENAU:** Professor Harner, I would wonder if the change in financing over the last 30 years doesn't point us more in the direction towards reorganizing the company in either event, because in the '70s the lending was much more focused on lending on receivables and lending on equipment on lending on inventory. Now with these purported blanket liens, it is difficult for a lender to even get repaid without the company either being sold or reorganized. In other words, unless you just really think that the hard assets are the best you can do, a regular state court foreclosure doesn't work for an operating entity. So that to me suggests that the survival of the business is where we're headed, both for the benefit of the creditor as well as the employees, the community, etc.

**PROFESSOR BRUNSTAD:** What really resonates with me, to sort of put it in a theoretical perspective, paying the claims is always just a wealth transfer. You're taking money out of one bucket, putting it into another. It's a wealth transfer. Saving the actual business so that it can go on and continue to produce a profit and employ people is a wealth enhancement. It actually makes us better off.

Now, of course you can't completely disregard the payment of the claims because of all the ex-ante effects that would have. You can't do that, but as between the two, if you think that what we really want to do here is maximize our overall social utility, not just some individual's benefit in a particular case, then you'll want to salvage these businesses because it really matters.

**PROFESSOR HARNER:** I'm sorry. I don't mean to interrupt. The only thing I want to push back on and why I think the Commission felt this was such a complex issue is it's one thing to say we're maximizing the value of the enterprise for societal value. It's a different thing to say we're saving the business which serves the goal of maximizing the value for the creditor so that the two policies can align at some point. Because I think in large part it depends who that creditor is. So if your creditor with the blanket lien is a hedge fund or a private fund that's been introduced into the secured financing at a late stage as "rescue financing," its objective may not be to maximize the value of the entity for societal utility. It may have a very different agenda.

**PROFESSOR BRUNSTAD:** Oh, yeah.

**PROFESSOR HARNER:** So, I think the policy concerns have been complicated by not only the evolution in financial markets and the blanket lien and the complexity of derivatives, but also who's trading in the claims and holding the debt at the point we're asking the question.

**PROFESSOR JACOBY:** And one more thing while we're looking at the big picture here, and I think this will segue into our next topic anyway. We have to remember that we are in a government with strong states' rights, limited federal powers. We do have a bankruptcy clause. The scope of the bankruptcy clause I think probably can still be debated, but the question of what the goals of bankruptcy are, I think they do dovetail because it seems like it would be more than protection of creditors' rights, which is a very important issue and does provide some baseline. But that is often, at least the beginning of that is state law. And so when bankruptcy does allow a firm to be worth more alive than dead, that is a premium that the federal bankruptcy system has allowed to be developed. And it's not clear that belongs to any one certain group of creditors or not. It is part of that company that may be up for play, but whether certain kinds of creditors with security interests can claim that, if you take that theory, then that becomes more complicated. It doesn't belong to them.

**PROFESSOR HARNER:** So should we maybe at this point transition to what might belong to the secured parties and think about financing? Because I think we have just enough time to do that. But before I do so, I feel like we distracted the conversation of sales to policy. Is there anything you would want to add to the § 363(x) provisions and permitting a sale of all or substantially all of the assets in certain contexts as opposed to the Wild West which it is now?

**PROFESSOR JACOBY:** Well, I don't want to belabor this, because I think the financing issue and the sale issue go hand in hand. So I think we've teed up the right kind of questions. I do want to emphasize that claims reserve is something that can absolutely be done today. It does not require legislation in the way that some of the other proposals do, so I fully endorse this concept that bankruptcy reform happen through all different channels and not just through statutory reform. Everything everyone's talked about on this panel shows that, that we have a Code written under very different times, but we have quite a distinct system today than in '78. But I do think that the financing piece is so tied into 363 sales that that is where I think it does make sense to go next.

**PROFESSOR BRUNSTAD:** So we've seen an evolution. We've seen an evolution in bankruptcy practice over the last 30 years, and in part that evolution has been driven by changes in finance. As Judge explained, we had a

situation historically where you'd have different lenders taking different liens on different things, but you didn't necessarily have all the assets liened up when the debtor went into bankruptcy.

Now we have a situation in which it's much more common for the ubiquitous blanket lien. A group of lenders may well have a lien on all the debtor's assets, at least the hard assets. There are of course some things you can't take a lien on, and that becomes an issue. But the blanket lien idea typically will give the secured lenders a lot of rights, a lot of rights under state law, and under our bankruptcy system, as traditionally conceived, a lot of potential leverage. And that has generated some abuses or some perceived abuses and some perceived problems, and includes such things as oftentimes you'll see very complicated capital structures with the senior secured lenders on top with intercreditor agreements that will do things like have covenants that say the junior creditors cannot without the senior secured creditors' consent provide DIP financing to the debtor entity. And this is an effort and attempt to gain control not only of the collateral but also subsequently of the bankruptcy process if there is one. And of course secured lenders are very acutely aware of and concerned about bankruptcy. After all, that's arguably one of the reasons why they took a security interest. If a debtor becomes insolvent, that's when their security interests become the most valuable. It's how they get preferred payment when otherwise they may not have been paid very much, and they rely on that, and they want to maximize their rights as secured lenders. They're smart, they're savvy, and so they increasingly over the years have figured out ways to try to translate that leverage into potentially control of the reorganization process. In a lot of ways, it has worked.

So the Commission, and again I applaud their efforts in trying to come up with some responses to this in the areas of financing and adequate protection, and they've done a lot I think of really good work. I want to summarize some of their recommendations, but I also want to ask a few questions.

First, in the concept of adequate protection, what should we do there? The problem is that if you say that a secured creditor is entitled to adequate protection at the fair market value or the reorganization value of the business, that's a very high value. What that might mean is that they end up getting a lot of value with respect to the assets. They may soak up all of the assets, and what that also means is that there may be no ability to provide them with adequate protection if in fact basically you're in a situation where you need their consent, especially if the secured lender has a lien on all the cash, all the

cash collateral. There's no head room for any subsequent financing or things like that. That gives the secured creditor a lot of leverage.

So the Commission has proposed kind of a compromise. On the one hand in bankruptcy, we want to respect the rights of the secured party, that at the end of the day what they should get is the reorganization value when we're talking about distribution of value at some point, and we're talking about determination of their claims. But for adequate protection purposes, we want to peg the value of their collateral at foreclosure value. That's what we want to respect, foreclosure value. That's the determining factor. So now what the idea would be, this would give the debtor more flexibility. When the secured creditor comes in, we peg the value at foreclosure value. To the extent there's excess value there, that can be used to help facilitate the reorganization process and takes away some of the control that the secured party might have.

There are also things like you can't do cross-collateralization, one of the recommendations, anymore, except to provide adequate protection. To the extent adequate protection proves to be inadequate, then you can have cross-collateralization. This idea that you can lien up prepetition debt with post-petition collateral, that's not going to be allowed. And so we have these various reforms.

So the question is, why this idea of giving the secured party reorganization value, what exactly does that mean? So I would suggest that, well, if the secured party is going to finance the reorganization, is actually going to put substantial new money into the enterprise to allow it to reorganize, then I think it makes sense to give them reorganization value because they're actually paying for it in a way, they're actually contributing to the reorganization. But if they're not going to do that, if they're just going to simply rely on the value of their claim, which arguably the debtor is trying to enhance the value of that through the reorganization process not only for the benefit of the secured party but for all the stakeholders, they should be stuck with foreclosure value for every purpose. So that's sort of one critique I throw out there. But obviously again, I recognize this is a compromise trying to get flexibility while trying to respect the rights of the secured parties, and I applaud that. But I sort of throw that one out, that idea out.

**PROFESSOR HARNER:** Can I just jump in real quick? I agree with the critique you raise, and it's an issue I think everyone needs to think about, but I just wanted to give everyone a point of reference. So I think the easiest way to conceptualize the concern Professor Brunstad voices is to think about the

blanket lien, and that really did not emerge in our system until the Uniform Commercial Codes were changed at the state level. And so you had a situation where the UCC's were changed at the state level to permit the blanket lien, taking a lien in all of the debtor's assets as opposed to just the equipment or just the inventory or just the plant. And as a result, what the testimony before the Commission stated, and we could disagree about the testimony, is that lending practices changed so that in evaluating the cost of the credit and the extension of the credit to the debtor, calculations were done on total enterprise value ("TEV") because the liens according to the secured creditors are valid with respect to the profits generated from the assets which is the TEV. And so that's where the concept of reorganization value came in, and it is a compromise. In fact, the Report, we tried to as artfully as we could be very forthcoming about the compromise reached between using foreclosure value and reorganization value. But that's the tension we're seeing with the fact that the Code really hasn't kept up with changes in markets and in state law because there is this now almost direct conflict between what was originally contemplated for secured creditor entitlements under the Bankruptcy Code and how those entitlements now are playing out under state law.

The other thing I think is interesting, you raised the leverage point, Professor Brunstad, and I think many believe that the foreclosure value standard, at least in the front end, probably many would welcome it on the back end as well, but on the front end would maybe reintroduce priming liens which you rarely see anymore. When's the last time you saw a debtor come in and prime the prepetition lenders with a priming debt? So that would be part of the leverage shift as well.

**PROFESSOR JACOBY:** Can I ask a question about the adequate protection proposal which does seem, again, back to state law, I feel like that does reflect state law entitlement. Yes, it's cheap and relatively easy to claim a security interest in lots of personal property under Article 9. Then the real property, there are some categories that aren't in there and some things that are not always property under state law, so I'm not sure they can capture all of those pieces in an Article 9. Even commercially reasonable disposition I don't see them getting all of those pieces. But did you see that as a firm departure from current law, the foreclosure value proposal?

**PROFESSOR HARNER:** So first, I agree with Professor Jacoby on the scope of state law and I think it's an open issue, and so part of it was setting a bargain forcing default rule where parties could then negotiate the resolution of that

state law issue and the conflict with the Bankruptcy Code. The foreclosure value concept was meant to be different. So currently under adequate protection litigation, you have three standards adopted by the courts. They'll use straight liquidation value, they'll use going concern or reorganization value, and then they'll use this thing that the courts have called in the past foreclosure value. And usually that's meant to contemplate the state law rights of the creditors and what they could recover under state law.

If you read the Report, the Commission tried to nuance the foreclosure value concept because again, in full honesty, we were very respectful of the state law rights, and the preference for state law entitlements even under our federal bankruptcy scheme. And so foreclosure value as used in the Commission's Report is meant to reflect what the creditor could actually receive in a commercially reasonable sale under state law, taking into account that although we always think you can only sell an asset in one state and you can never do a true going concern sale under state law, I will tell you there are true going concern sales happening under state law, and so the creditor could show the ability to stack the foreclosures in order to get the TEV. In theory, the foreclosure value may not look much different than reorganization value, but again it was meant to set a bargain forcing default rule and hopefully create value for the estate.

**PROFESSOR BRUNSTAD:** The next area of recommendations is with debtor-in-possession financing. I think there are some very creative and excellent proposals here. Some of them fall under the heading, if you prohibit it outright in the Code, then creditors won't ask for these things anymore. If you don't prohibit it, they're always going to try to ask for it. And these fall into the category of cross-collateralization. Cross-collateralization is very controversial. That's where—

**PROFESSOR JACOBY:** Especially in the Eleventh Circuit.

**PROFESSOR BRUNSTAD:** Especially in the Eleventh Circuit where it's prohibited after *Saybrook*.<sup>17</sup> And *Saybrook* is actually a good illustration. There the secured creditor had a \$24 million deficiency, \$34 million in debt, only \$10 million in collateral, \$24 million in unsecured debt. And the creditor said I'll give you \$3 million, Debtor-in-Possession, if you give me a lien covering all the rest of my claims. So went from being a \$24 million deficiency to potentially being fully secured to the tune of \$34 million. And the unsecured

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<sup>17</sup> See 963 F.2d 1490 (11th Cir. 1992).

creditors went nuts. This is just an asset grab, they say. This was not a legitimate financing. They're not giving something that's going to help us all. And so the proposal is just to prohibit cross-collateralization except, as I mentioned, for adequate protection. No roll-ups and no pay-downs. You can't roll-up the prepetition debt into the postpetition facility to essentially accomplish cross-collateralization that way. And no pay-downs except using basically postpetition financing to pay off prepetition debt, except where you're paying off unaffiliated debt, debt that's unaffiliated with the postpetition lender, or if you're paying off affiliated debt where the secured postpetition lender typically is providing substantial new money and it's on terms that are more favorable than otherwise would be available.

So the idea here, and I think it's an excellent one, is we want to prohibit some of these abuses or these perceived abuses that seem to be giving too much leverage and giving away the candy store potentially, and these asset grab situations, but we want to maintain flexibility. Then they also propose no liens on avoidance actions; we're going to keep those recoveries lien-free. And you can have what's called permissible extraordinary financing provisions like benchmark provisions and things like this, performance provisions, but you have to take care within the first 60 days that you're not basically going to impose these things and put these artificially short deadlines on debtors within that 60-day breathing spell. Again, I think this is an excellent idea.<sup>18</sup>

And there's also this override of what we see in these inter-creditor agreements, an override where these inter-creditor agreements that say junior lenders, subordinated junior lenders can't provide DIP financing without the consent of the seniors, which of course they don't give. So this would be a provision that says, no, we're going to override that, those are unenforceable. The juniors can provide DIP financing, provided they aren't trying to prime the senior liens and provided that the senior lenders have an option to come in on at least the same terms and provide the financing themselves. And this of course is designed to increase flexibility and level the playing field some more so that we have a system that actually I think is more designed towards facilitating reorganization, and it dovetails with the provisions on sales.

There are also some provisions you can't waive, the § 506(c) surcharge, but then again the idea the surcharge should only apply to prepetition debt. And you can't waive the § 552 equities of the case provision, which I also thought was a beneficial thing. We don't have time to go into all the details of these

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<sup>18</sup> See Am. Bankr. Inst. Comm'n to Study the Reform of Chapter 11, *supra* note 1, at 67–73.

things. But these it struck me are some really valuable, good reforms. Again, they kind of fall under the heading, if you prohibit some of these things then creditors won't ask for them, and we can focus on other things like the financing terms and terms that actually could help reorganize the debtor and don't sort of give us this cause for concern that what really is trying to go on here is the problem that seemed evident in *Saybrook* where the secured creditor seemed like, by putting in a little money was just going to walk away with all of the assets.

I think we have a little time left. I just wanted to mention some of the plan reorganization issues, two of them, unless others want to comment on what I just said.

**PROFESSOR HARNER:** Well, I just wanted to ask the Judge a question. I think part of the objective in the financing, and actually many of the recommendations but particularly financing was again finding a way to respect state law entitlements as we're mandated to do in the federal bankruptcy system, but reinstilling some voice, some leverage for the debtor which seems to be missing. From your experience, is that an accurate perception? Has there been a shift in balance to where the debtor really has no leverage in these discussions? And is that appropriate or inappropriate? Where should the balance lie when we're thinking about the playing field that Professor Brunstad mentioned?

**JUDGE HAGENAU:** I do think the debtor has minimal leverage. That's why in a case that supports it, a creditors committee is important because they're the ones that actually come in and argue don't give the waiver, don't give up the avoidance actions, don't give up this, don't give up that, because the debtor is typically in a position where only one entity is offering the postpetition financing, and the creditor or the buyer, whoever it is that's offering the money always says it's this or nothing. The debtor doesn't want the nothing, so they're kind of between a rock and a hard place. And so I think this really gives the debtor additional leverage, and it addresses most of the points that a committee objects to at the outset, and I think buys some time for everybody to sort of settle into the case, see what's going on and what actually makes sense.

**PROFESSOR HARNER:** That's very helpful, and I'm glad you brought up the committee. So, there was a strong push among some at the hearings to eliminate the use of creditors committee, but as the Judge just articulated, the Commission found huge value in the role they can serve, provided they have

the time to get the information and raise the objections and support the debtor or at least the other constituents.

**PROFESSOR JACOBY:** I think abolishing the creditors committee concept, which I have also heard people raise outside of your Commission process, is premised on the assumption that we're in a static sort of almost permanent state of capital structures and how money is going to be invested and loaned in the future. I don't know that we should make that assumption at all.

**PROFESSOR HARNER:** I'm getting the sign from Ms. Deppert over here, so I don't think we're going to have time to run through the plan unless you want to tick them off very quickly. You're very efficient, so go ahead.

**PROFESSOR BRUNSTAD:** I would just say the new value corollary would be codified, someone who gives new money or money's worth, reasonably proportionate to the interest retained, subject to the a market test when the equity does this, they can keep their equity. And then on cramdown interest rates, the idea is to reject the prime plus, the formula approach, and to go with either a market rate in chapter 11 if it's available or basically an approximation of the market rate if a market rate isn't available under the circumstances, rejecting the bankruptcy court's opinion in *Momentive*,<sup>19</sup> which adopted the chapter 13 prime plus formula rate, and to give that to the secured party as the present value, reflecting the present value of its claim. So, those are actually beneficial things that I also think are great ideas.

**PROFESSOR HARNER:** Well, I want to thank all our panelists. I will tell you over the past year I have done almost 40 different presentations on the Commission Report, and I don't mean this to be derogatory of any of my other panels, they're all fantastic, but I think we pulled out concepts and policy issues that haven't yet been discussed before, so I appreciate those insights, and I would encourage you all to read the Report. It's great bedtime reading. Put you right—no. There's a lot of history and case law in the Report, and that was done intentionally. The ABI is an educational institution. Our mission is to educate, and we hope that if nothing else, we have a better informed bar, thinking about ways to use the Code and thinking about ways to make it better. So, I hope the dialogue about reform continues and I'm happy to talk with anyone about reform. Just find me at Maryland's website and shoot me an email. Thank you again.

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<sup>19</sup> See No. 14-22503-RDD, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014), *aff'd*, 531 B.R. 321 (S.D.N.Y. 2015).

**MS. DEPERT:** And with such a tremendous amount of knowledge and experience on this stage, I wanted to be able to open the floor for maybe one or two questions for our panelists if anyone has one.

**PROFESSOR JACOBY:** We have a couple of professors up here who might call on someone.

**AUDIENCE MEMBER:** I enjoyed your comments about reforms of DIP financing. One of the things you said, this idea that you could have rollups in particular circumstances including being able to demonstrate that the pricing was better than anything else available. My experience is that there really is never competitive DIP bidding, so that I just wonder how often we're going to find a better or a comparative offer out there to decide whether this debtor has met.

**PROFESSOR BRUNSTAD:** That's an excellent point. A case of competitive DIP bidding was of course the *Ames* case that Judge Bushman took. It's a very famous case. It's wonderful. There, the pre-existing lender, Citibank, offered 40 million in new money, provided you had a roll-up, and of course that's typical existing creditor type of response, but because the postpetition facility was going to be secured, but the nice thing about *Ames*, which we don't see too often was that the existing creditor was unsecured completely, and so you can have DIP financing shopping because Chemical Bank came in and said, we'll give you \$250 million, but we'll do it on a superpriority basis. You don't have to give us a lien as long as there are no liens that are allowed, and they beat out Citibank.

Your comment is great because it underscores, usually the source of funding is going to be the existing lenders for a lot of reasons. They have intimate knowledge of the debtor, they have something at stake, they are invested. And Grant Gilmore had this very famous theory about why we like security interests. Because the secured party is invested, it's basically forced to participate in ways hopefully that will help everybody. But what I see this proposal as doing is forcing that existing lender to actually fulfill that role, the Gilmorian role of the good cop on the block who's going to help police the process and actually enhance it. You can't walk away with the goodies; you've got to make a decision based upon your knowledge of whether you're going to invest further. And I think that the Code should reward that constructive behavior and should not reward the opposite where the secured creditor just sits back, doesn't contribute anything new but expects all the benefits. So

actually I think these proposals are wonderful because they help fulfil the Gilmorian vision of the virtuous secured lender.

**MS. DEPERT:** Thank you. Let's give our corporate panelists one more round of applause.