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Distressed Investing, Mergers & Acquisitions

An Overview of the Legal Landscape for Acquirors and Investors

2022

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Introduction

This outline focuses on investments in, including mergers with and acquisitions from, "distressed" companies. Distress for this purpose means that a company is facing challenges in 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.

Investing in distressed companies presents unique opportunities and also involves unique legal issues. To capitalize on the former, it is critical to carefully analyze the latter.

Part I of this outline reviews the menu of "out-of-court" corporate responses to debt crises. Some modestly distressed companies require a mere "band-aid," while others require "major surgery." The out-of-court responses may offer opportunities for investors to position themselves to acquire control of a corporate debtor or its assets.

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. They tend to result in cheaper, faster, less confrontational bankruptcies. 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 or assets in and through a bankruptcy case. Acquisitions of assets, discussed in Part III.A, may be made pursuant to section 363 of the Bankruptcy Code on a relatively expedited basis. 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. Finally, rights offerings in connection with a reorganization plan are discussed in Part III.C.

Part IV of this outline addresses specific considerations regarding the acquisition of debt of distressed companies as a strategy for obtaining control over the company or specific assets.

We welcome your comments or questions on this outline.

I.

Out-of-Court Workouts of, and Acquisitions from, 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 find themselves unable to deliver clean (unqualified) audit opinions or satisfy material adverse effect or solvency-related conditions needed to draw on a revolving line of credit. Impending debt maturities may also be potential sources of financial difficulty.

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 new capital.

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.

Because a forbearance is not a waiver of the underlying event of default, during the period of forbearance, interest typically continues to accrue at the rate applicable

after an event of default has occurred and the continued existence of an event of default generally makes it impossible for the company to draw on lines of credit. The possibility of default under other credit documents, including through cross-defaults, can affect the options of both the company and the forbearing creditors. A lender considering granting a forbearance frequently will condition such forbearance on the agreement of all other lenders that could assert a default to forbear during the specified period.

2. Waivers and Amendments

Alternatively, a debtor that either is in breach of a debt covenant or anticipates a future breach may seek a waiver of that breach or an amendment of the governing agreement. 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.

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.

a. *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. 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 approval of each affected lender.

The process of negotiating and obtaining waivers or amendments may raise important federal securities law issues for the issuer, debtholders, and potential debt purchasers. To procure the requisite lender consents, an issuer of debt securities typically will undertake a consent solicitation. If a distressed company has issued public securities—regardless of whether the debtor is seeking to amend those

securities—federal securities laws will apply, prohibiting issuers from making selective disclosure of material nonpublic information, and investors from 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. For this reason, such creditors and investors may insist that such information be made public by a specified "blow out" date, allowing trading to resume.[1]

In evaluating the level of consent required to obtain an amendment as well as the effect of a proposed amendment, any limitations on the voting status of outstanding debt must be considered.

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 credit agreements and "144A for life" and other unregistered notes, the question of voting is decided by contract.

b. *Tax Implications*

A waiver or modification of debt can have significant tax consequences for both issuer and creditor.[3] For a potential investor in a distressed company, both can

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[1] See Part IV.C.3 for further discussion of trading restrictions and strategies used by distressed debt holders who are negotiating with a distressed issuer.

[2] 15 U.S.C. § 77ppp(a).

[3] A change that occurs by operation of the terms of the debt instrument generally is not a modification. *See* 26 C.F.R. § 1.1001-3(c)(1)(ii); *but see id.* § 1.1001-3(c)(2) (exception for alterations that change the obligor or the nature of the instrument). 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) or arises from the exercise of a unilateral option provided to an issuer or holder to change a term of the debt instrument (and, in the case of an option exercisable by a holder, it does not result in a deferral of, or a reduction in, scheduled payment of interest or principal). *See id.* § 1.1001-3(c)(1)(ii); *id.* § 1.1001-3(c)(2). 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.

impact the attractiveness of a deal. The consequences depend on whether the waiver or 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 income ("CODI") 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.2.b.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 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."[6] 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.[7] For example, a change to the pricing of a debt instrument may result in a significant modification if the yield on the instrument changes by more than a specified amount.[8]

In the case of a significant modification of debt or an actual exchange of debt for debt or equity, the resulting CODI 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 CODI may be considerable. However, in the case of a debt modification or debt-for-debt exchange, the CODI

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[4] *See* 26 C.F.R. § 1.1001-3.

[5] *See* 26 U.S.C. § 61(a)(11); *id*. § 1273(a).

[6] 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.

[7] *See* 26 C.F.R. §§ 1.1001-3(e)(2), (3), (4), (5) & (6).

[8] A change in yield constitutes a significant modification if the yield of the modified debt differs from the yield of 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. *See* 26 C.F.R. § 1.1001-3(e)(2)(ii); 26 C.F.R. § 1.1001-3(f)(3).

generally will be offset by future OID deductions.[9] Further, an issuer that is insolvent or in bankruptcy may be able to exclude all or a portion of the resulting CODI. These and other tax issues are explained in greater detail in Part I.B.2.b.viii.

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 floating interest rates. Other typical requests include commitment reductions on revolving credit lines, additional collateral, paydowns, and new caps on investments and dividends.

B. Borrower Opportunities in the Face of Distress

When a distressed company's debt trades below par, it creates an opportunity for potential acquirors who may wish to purchase debt as a means for acquiring assets—*i.e.*, a "loan-to-own" strategy, discussed further in Part IV. However, it also presents an opportunity for a debt issuer to de-lever itself by repurchasing some or all of its own debt or exchanging old debt for new on more favorable terms. Likewise, the debt issuer's equity holders—particularly when the debt issuer is privately held—may seek to purchase the discounted debt.

1. Debt Repurchases

a. *Bank Debt Repurchases by the Borrower or its Affiliates*

Before the 2008 financial crisis, credit agreements typically prohibited both (1) borrowers and their affiliates from buying loans and (2) lenders from receiving "non-pro rata" payments on their loans. While these types of limitations still often appear in revolving loans and most "term loan A"—*i.e.*, shorter duration loans made principally by commercial banks, with significant amortization during the life of the loan—facilities, the "term loan B" market—*i.e.*, the market for longer term loans syndicated to a broader set of hedge funds and other institutional investors with limited amortization—has evolved significantly.

Today, it is common for term loan B facilities to permit repurchases of loans by a borrower on a non-pro rata basis (with such purchased loans deemed immediately cancelled upon purchase). Some facilities contain limitations on the amount of

[9] 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.2.b.viii.

loans that may be purchased, the timing thereof, and the mechanism pursuant to which the purchase occurs, though these limitations have gotten weaker over time, but increasingly many contain few or no such restrictions. As such, a borrower that has cash on hand and believes the market is undervaluing its debt can often elect to repurchase its loans at the best price available from whichever lenders may be willing to sell to it.

Flexibility for affiliates to acquire loans has also increased dramatically. Many term loan B facilities today allow affiliates to buy a borrower's outstanding loans, so long as they at no time hold more than 25% to 30% of the aggregate loans outstanding. However, the types of matters on which affiliate lenders may vote under the credit agreement are typically limited (*e.g.*, affiliates can vote only on an extension of maturity and reduction of principal or interest).

b. *Preference Risk to Selling Creditor*

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 (*e.g.*, a payment or the grant of a lien) to a creditor on account of a previously existing debt can be unwound if it was made within 90 days of a bankruptcy filing (one year for transfers to insiders), when the borrower was insolvent (which is presumed) and it leaves the creditor better off than it would have been had the transfer not been made and the borrower were liquidated under chapter 7 of the Bankruptcy Code.[10] Thus, the creditor whose debt was repurchased by the company may find itself the target of a preference action by the bankruptcy estate to recover the amount paid.

c. *Corporate Opportunity Doctrine*

Sponsors and affiliates acquiring loans issued by their borrower should also assess any implications under the "corporate opportunity" doctrine. This doctrine 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 it, unless

[10] *See* 11 U.S.C. § 547(b).

the person first presents the opportunity to the company and obtains its informed approval to pursue it.[11]

d. *Equitable Subordination*

Another risk for parties that buy debt in an issuer with which they have a relationship is the potential for the 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 to remedy harm suffered as a result of inequitable conduct.[12] 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" if 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. In general, equitable subordination is viewed as an extraordinary remedy, but it is more readily applied by courts where the creditor is an insider of the debtor.[13]

e. *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

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[11] 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 Look at Corporate Opportunities* (Columbia L. Sch. Ctr. L. & Econ. Studies, Working Paper No. 235, 2003), http://ssrn.com/abstract=446960.

[12] *Schubert* v. *Lucent Techs. Inc. (In re Winstar Commc'ns, Inc.)*, 554 F.3d 382, 411 (3d Cir. 2009) ("'[T]hree conditions must be satisfied before exercise of the power of equitable subordination is appropriate:' (1) '[t]he claimant must have engaged in some type of inequitable conduct;' (2) '[t]he misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant;' and (3) '[e]quitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy [Code].'" (quoting *Benjamin* v. *Diamond (In re Mobile Steel Co.)*, 563 F.2d 692, 699-700 (5th Cir. 1977))); *Sure-Snap Corp.* v. *State Street Bank & Tr. Co.*, 948 F.2d 869, 876 (2d Cir. 1991) (quoting *Mobile Steel* standard); *In re Aeropostale, Inc.*, 555 B.R. 369, 397 (Bankr. S.D.N.Y. 2016) (same).

[13] *United States* v. *State St. Bank & Tr. Co.*, 520 B.R. 29, 81 (Bankr. D. Del. 2014) ("The type of misconduct that will satisfy the first prong varies depending on whether the alleged bad actor is an 'insider' of the debtor. When the claimant is an insider, the standard for finding inequitable conduct is much lower. . . . 'A claim arising from the dealings between a debtor and an insider is to be rigorously scrutinized by the courts.'" (quoting *In re Winstar Commc'ns, Inc.*, 554 F.3d at 412)).

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.[14]

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. Although recharacterization and equitable subordination are often sought as alternative remedies, one court has emphasized that the remedies "address distinct concerns," *i.e.*, whether equity demands a change to payment priority in the case of equitable subordination, versus "whether a debt actually exists."[15] The gist of the recharacterization analysis is "typically a commonsense conclusion that the party

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[14] *See, e.g.*, *Weisfelner* v. *Blavatnik (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); *Cohen* v. *KB Mezzanine Fund II, LP (In re SubMicron Sys. Corp.)*, 432 F.3d 448 (3d Cir. 2006) (recognizing power to recharacterize, but affirming refusal to do so); *Bayer Corp.* v. *MascoTech, Inc. (In re Autostyle Plastics, Inc.)*, 269 F.3d 726 (6th Cir. 2001); *Hartford Holdings, LLC* v. *Mladen (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 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 "[t]he overwhelming weight of authority supports the proposition that bankruptcy courts act within their equitable powers when they recharacterize loans as infusions of equity").

[15] *In re SubMicron Sys. Corp.*, 432 F.3d at 454 (internal quotation marks and citation omitted); *see also, e.g.*, *Aquino* v. *Black (In re AtlanticRancher, Inc.)*, 279 B.R. 411, 432-33 (Bankr. D. Mass. 2002) (considering request for both remedies in the alternative and observing that they are "separate cause[s] of action").

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)."[16]

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.

f. *Insider Trading*

A company considering a debt buyback must consider applicable federal and state securities and antifraud rules, including, in the case of purchases of securities, Rule 10b-5 of the Exchange Act.[17] Interests in bank debt typically have not been considered to be securities for purposes of the federal securities laws,[18] but companies buying their own debt could still face claims for wrongdoing, such as common law fraud.

g. *Tax Considerations*

Debt repurchases, if made at a discount, generally will give rise to CODI.[19] This topic and other considerations are discussed in greater detail in the context of exchange offers in Part I.B.2.b.viii.

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

[17] 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).

[18] *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").

[19] *See* 26 U.S.C. § 61(a)(11); 26 U.S.C. § 108(e)(4).

2. Exchange Offers

An exchange offer may give a financially troubled company the chance to de-lever—for instance, by exchanging new secured bonds for old unsecured bonds at a discounted exchange ratio—or to address maturities—for instance, by offering a new security with better economics for an old security that is coming due. It may give existing creditors the chance to improve their position relative to other creditors, or to 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. However, in other instances, particularly where the new security is longer-dated than the old security, "holdouts" may benefit from becoming "first in time" to be repaid; in these scenarios, it is common for the offer to be conditioned on there being no more than a de minimis amount of holdouts.

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. Whether these exit consents are truly painful to "holdouts" is circumstance-dependent, with the key factor being whether the provisions that are permitted to be amended under the debt documents without the holdouts' consent have any direct economic ramifications. For example, removal of guarantees and collateral could materially affect the trading value of a security, whereas other changes may not.[20]

a. *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

[20] The Trust Indenture Act (the "TIA"), which applies to all bonds issued in registered offerings, 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." 15 U.S.C. § 77ppp(b). In *Marblegate Asset Management, LLC* v. *Education Management Finance Corp.*, the U.S. Court of Appeals for the Second Circuit reversed a controversial district court decision which had held that both a bondholder's *legal* right to sue for payment and its *practical* right to receive payment are protected. 846 F.3d 1 (2d Cir. 2017). The Court of Appeals ruled that the TIA prohibits only formal amendments to an indenture's "core payment terms"—*i.e.*, the amount owed and the date of maturity—but does not prohibit 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.

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.[21]

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.[22] 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.[23] 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.[24] The company only emerged from bankruptcy in January 2016 after a lengthy period of negotiations with creditors.[25]

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[21] 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.

[22] *See* Press Release, CEVA Group Plc, *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), www.cevalogistics.com/release/2-May-2013-1.

[23] *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 (Bankr. D. Del. May 13, 2013), ECF No. 166.

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

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

b. *Additional Considerations in Structuring Exchange Offers*

Regulation 14D under the Exchange Act does not apply to offers to exchange non-convertible debt.[26] 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 exemption 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 qualified institutional buyers (or "QIBs") under Rule 144A of the Securities Act, and non-U.S. holders pursuant to Regulation S. 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 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

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

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.[27]

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 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.

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[27] 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.

(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 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.

In certain circumstances—usually where the major holders of the existing securities are a small, concentrated group of sophisticated investors—exchanges can be done on a fully private basis that does not utilize an underwriter or dealer manager, in which case the disclosure requirements can be significantly reduced.

(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. In practice, to avoid the need for registration, distressed exchange offers are usually made pursuant to such an exception, specifically to QIBs under Rule 144A of the Securities Act and non-U.S. holders pursuant to Regulation S.

(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 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."[28] 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.[29] 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 ratings 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 CODI. 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.[30] 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.[31] For example, if a borrower borrows $100 and then, sometime later, settles the loan for only $60, the borrower will have $40 of CODI.

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[28] 15 U.S.C. § 78m(d)(3).

[29] 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).

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

[31] 26 C.F.R. § 1.61-12.

CODI generally is taxable.[32] However, depending on the circumstances, issuers that incur CODI may be able to reduce, eliminate, or entirely exclude 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 CODI.[33] If the losses are large enough, they may substantially reduce the tax that would otherwise be imposed on the CODI. Issuers relying on NOLs to reduce CODI should be aware, however, that NOLs arising in taxable years beginning after December 31, 2020 may only be used to offset up to 80% of taxable income (including CODI) for a taxable year.[34] Second, an issuer may exclude CODI if the issuer is in bankruptcy or insolvent.[35] If the issuer is insolvent, the exclusion is available only to the extent of the insolvency.[36] Any CODI excluded under the bankruptcy or insolvency exception generally must be matched by a corresponding reduction in the issuer's tax attributes, including NOLs.[37]

Exchanges. An exchange of debt for anything—including new debt, stock, or cash—is treated as a repayment of the original debt. As such, if the value of the property or cash exchanged for the debt is less than the amount of the old debt, the issuer will recognize CODI. CODI 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.[38] 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

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[32] *See* 26 U.S.C. § 61(a)(11).

[33] *See id.* § 172(a).

[34] *See id.* While this limitation was originally to be imposed for taxable years beginning after December 31, 2017, the Coronavirus Aid, Relief, and Economic Security Act delayed the applicable year. *See* Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. No. 116-136, § 2306, 134 Stat. 281 (2020).

[35] *See* 26 U.S.C. §§ 108(a)(1)(A)-(B).

[36] *See id.* § 108(a)(3).

[37] *See id.* § 108(b). Occasionally, the amount of the excluded CODI exceeds the issuer's tax attributes required to be reduced, in which case the issuer is able to exclude the excess CODI (referred to as "black hole" CODI) without any offsetting detriment.

[38] 26 C.F.R. § 1.61-12(c)(2)(ii).

of the old debt is the issue price of the old debt, increased by any accrued original issue discount.[39]

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.[40] The issue price of the new debt depends on whether the old debt or the new debt is "publicly traded"—in this case referring not to registration or listing on an exchange, but simply to whether there exists a reasonable market with ascertainable price quotes for the debt in question, as discussed below. If the new debt is publicly traded, then the issue price is its fair market value.[41] 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.[42] 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.[43]

As 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 CODI. 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 CODI. 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 it normally would, then the issue price of the new debt is $100 and the issuer will not have any CODI. Thus, a distressed issuer of publicly traded debt that is exchanged for new debt will often have CODI.

The definition of "publicly traded" changed in 2012. The prior definition was broad and anachronistic, and had been much criticized as containing numerous

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[39] *See* 26 U.S.C. § 1272(a)(4).

[40] *Id*. § 108(e)(10).

[41] *See id.* § 1273(b)(3); 26 C.F.R. § 1.1273-2(b)(1).

[42] *See* 26 C.F.R. § 1.1273-2(c)(1).

[43] *See* 26 U.S.C. § 1274(a)(1); 26 C.F.R. § 1.1274-2(b)(1). The AFR is a schedule of interest rates published by the Department of the Treasury every month.

ambiguities, especially in light of modern trading practices.[44] In 2012, the IRS finalized new regulations intended to simplify and clarify this definition.[45] Generally, under these rules, a debt instrument is 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").[46] While the new definition has been praised as being clearer and simpler than the prior regulations,[47] it has generally caused more debt instruments to be treated as "publicly traded"—and thus caused more issuers to realize CODI—than the former definition. Since price quotes or recent sale prices for debt often can be found on the internet,[48] debt that one might not expect to be publicly traded may prove to qualify under this definition.

As discussed in Part I.A.2.b 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 CODI as a result of a modification to a debt instrument.[49] Thus, renegotiation of a debt instrument must be reviewed from a tax perspective to determine if it results in a significant modification. 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. Often, in the context of a distressed company, a renegotiation of a debt instrument will result in a significant modification for tax purposes.

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[44] *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).

[45] *See* 26 C.F.R. § 1.1273-2(f).

[46] 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. *See id.* § 1.1273-2(f)(6).

[47] *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").

[48] *See, e.g.*, *Trade Reporting and Compliance Engine (TRACE)*, FINRA, www.finra.org/filing-reporting/trace (last visited April 1, 2021).

[49] 26 C.F.R. § 1.1001-3.

OID. If a debt-for-debt exchange results in CODI, it also may generate future 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 CODI in the year of the exchange (subject to the bankruptcy and insolvency exclusions described 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.[50] In our example, the stated redemption price at maturity, which generally is the face amount, is $100 and the issue price is $60. Thus, the new debt has $40 of OID (which, not coincidentally, is equal to the amount of CODI on the exchange). The OID generally is deductible by the issuer over the term of the debt instrument (subject to certain limitations discussed below).[51] Thus, in a debt-for-debt exchange in which the new debt has the same principal amount as the old debt, the CODI 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 CODI, however, 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 the limitations discussed below) while the CODI generally is includible in the year of the exchange. Nonetheless, the OID deductions can ameliorate the tax cost of the CODI.[52]

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

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[50] 26 U.S.C. § 1273(a)(1).

[51] *See id.* § 163(e)(1).

[52] 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. (In re Res. Cap., LLC)*, 501 B.R. 549, 586 (Bankr. S.D.N.Y. 2013); *In re Allegheny Int'l, Inc.*, 100 B.R. 247 (Bankr. W.D. Pa. 1989).

December 31, 2017, which were further altered in 2020 by the CARES Act.[53] 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% of the taxpayer's "adjusted taxable income" (a measure conceptually similar to EBITDA for taxable years beginning before January 1, 2022 and EBIT for taxable years beginning after January 1, 2022).[54] The CARES Act generally increased this limitation for taxable years beginning in 2019 and 2020 to 50% of a taxpayer's adjusted taxable income, rather than 30%.[55] Because the limitation is primarily a function of a taxpayer's taxable income, distressed issuers are more likely to have interest expense in excess of the limit. Additionally, issuers that recognize CODI due to the modification or exchange of a debt instrument may be especially harmed by this rule, as it may disallow current interest deductions attributable to the OID with which the new debt is deemed to be issued.[56] Disallowed interest deductions can be carried forward indefinitely, and will be treated as interest paid in subsequent taxable years.[57]

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 equal to or greater than the AFR plus 5%, and "significant OID,"

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[53] *See* 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. *See id.* § 163(j)(3).

[54] *Id.* § 163(j)(8)(A)(v).

[55] *See id.* § 163(j)(10)(A)(i). Interest deductions of partnerships for taxable years beginning in 2019 and 2020 are subject to special rules. *See id.* §§ 163(j)(10)(A)(ii), (iii), 163(j)(10)(B).

[56] As discussed in Part I.B.2.b.viii of this outline, if not disallowed, these deductions can help to ameliorate the tax cost of CODI. The IRS previously solicited comments on the interaction between the interest deduction limitation and the rules addressing CODI. In 2020, the IRS stated that "in light of the complex and novel issues" raised in the comments received, it had determined that this interaction requires further consideration and may be the subject of future guidance. T.D. 9905 (Sept. 14, 2020).

[57] *See* 26 U.S.C. § 163(j)(2). However, a company's ability to use such interest deductions in future years may be limited by section 382 of the Internal Revenue Code if there is an "ownership change," which is discussed in Part IV.C.1.e of this outline. Additionally, 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.

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).[58] 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.[59] 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.[60]

The AHYDO rules exact a painful toll on a distressed issuer. The tax on CODI 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.

Debt-for-Stock Exchanges. As noted above, an exchange of stock for outstanding debt can also result in CODI to the issuer because, for purposes of the CODI rules, a company is treated as satisfying its indebtedness for an amount equal to the fair market value of the stock issued in exchange.[61] 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 CODI in the amount of such excess. However, the tax cost of the CODI 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 CODI. CODI 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).[62]

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[58] *See id.* §§ 163(i)(1) & (e)(5)(A). "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. *See id.* § 163(i)(2).

[59] *See id*. § 163(e)(5). The yield that exceeds the AFR plus 6% is non-deductible, while the rest of the yield is only deductible when paid in cash. *See id*. 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.

[60] *See id.* § 163(e)(5)(B).

[61] *See id.* § 108(e)(8)(A).

[62] *See id*. §§ 108(a)(1), (3). If debt is owed by a wholly owned subsidiary that is a "disregarded entity" for federal income tax purposes, the regarded owner is considered the "taxpayer" for purposes of applying both the insolvency and bankruptcy exceptions to CODI. *See* 26 C.F.R.

However, the ability of a taxpayer to exclude CODI comes at a price. A taxpayer that excludes CODI 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 CODI.[63] If the taxpayer has no tax attributes to be reduced, the CODI may be excluded with no further consequences.[64]

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).[65] If an exchange offer results in an "ownership 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."[66] As a result, an issuer that undergoes an ownership change generally will have a higher effective tax rate in subsequent years to the extent that the resulting "section 382 limitation" prevents it from fully utilizing its pre-ownership-change NOLs against taxable income. Part IV.C.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

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§§ 1.108-9(a)(1), (3). Thus, CODI resulting from the discharge of indebtedness of a disregarded entity may only be excluded if the regarded owner itself is in bankruptcy or insolvent. Similarly, if debt is owed by a partnership, a partner's eligibility for the bankruptcy and insolvency exceptions is determined at the partner level. *Id.* § 1.108-9(b).

[63] *See* 26 U.S.C. § 108(b).

[64] If the debtor is a member of a consolidated group, excluded CODI 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. *See* 26 C.F.R. § 1.1502-28(a)(4); *see also Marvel Ent., LLC.* v. *Comm'r*, 842 F.3d 1291 (2d Cir. 2016), *aff'g* 145 T.C. 69 (2015).

[65] 26 U.S.C. §§ 382(a), (g).

[66] 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.C.1.e.

person.[67] Accordingly, the issuer may recognize CODI 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.[68] 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.[69] As discussed above, generally the issue price of the new debt will be its fair market value if the debt is publicly traded. If the new debt is not publicly traded, then, if it is exchanged for old debt that is publicly traded, the issue price of the new debt generally will be the fair market value of the old debt (and carries an interest rate at least equal to the AFR), otherwise 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.[70] 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.[71] "Securities" for this purpose are debt instruments that provide an issuer with a long-term proprietary interest in the issuer.[72] 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.[73]

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[67] *See* 26 U.S.C. § 108(e)(4); 26 C.F.R. § 1.108-2.

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

[69] *See* 26 U.S.C. § 1001.

[70] *See id.* § 368(a)(1)(E).

[71] *See id.* §§ 354(a)(1) & 358.

[72] *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.").

[73] 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. *See* Rev. Rul. 2004-78, 2004-2 C.B. 108.

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.[74]

C. A New Dynamic in Intercreditor Relations

The past decade has brought a dramatic shift in the negotiating dynamics of distressed situations: The prevalence of borrower-friendly debt documents has empowered even distressed borrowers in their dealings with their creditors. And the replacement of "traditional" lenders with specialized funds, many with deep experience in distress, has changed the rules of intercreditor behavior. As a result of these changes, today there is more contractual ability, and greater willingness of creditors, to engage in aggressive exchange offers that favor one group of lenders in a class to the detriment of others in that same class. It has long been the case that borrowers negotiated hard with their creditors, and that creditors of one class negotiated and fought with creditors of another class. But the introduction of intra-class competition among lenders has resulted in new levels of complexity, opportunity, and risk.

As a result of these changes, it is increasingly common for distressed companies to generate competition among their lenders to engage in favorable exchange and financing transactions. Utilizing covenant carveouts and/or majority-lender amendment provisions (as opposed to unanimous consent amendment provisions), companies have been able to (i) issue "new money" debt secured by a senior lien on collateral that had previously secured *existing* debt on a senior basis, and/or (ii) capture "discount" on its existing debt by enticing its debtholders to exchange their debt for new senior debt in a lesser principal amount, while subordinating previously secured debt through structural means or new intercreditor agreements.

As a result, creditors of a distressed borrower (including would-be acquirors hoping that trading discounts have enabled them to purchase potential control stakes at a favorable price), can find themselves faced with the risk of significant economic downside, including reductions in their expected recovery in a bankruptcy of the borrower. As creditors seek leverage and compete to strike a deal with the borrower, those who come to terms with the borrower are likely to benefit, while those who do not may find they not only have been shut out of an appealing transaction, but also that the value of their existing position has been significantly diminished.

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[74] *See* 26 U.S.C. § 1272(a)(1). *See also* Part I.B.2.b.viii.

Creditors in these situations should consult with their advisors promptly, be nimble and creative, work to build a "group," and negotiate with the borrower. "If you are not at the table, you're on the menu," as the saying goes.

Examples of the mechanisms that have been employed in these situations follow.

1. Asset Drop-Downs

In what is often called a "J. Crew" transaction, borrowers (including, among others, J. Crew,[75] Hornblower,[76] and Travelport[77]) took advantage of investment "basket" capacity to contribute assets to "unrestricted subsidiaries"—*i.e.*, subsidiaries that are not required to give guarantees or grant collateral and are not restricted by the debt document's covenants. Those unrestricted subsidiaries then raised new financing secured by the contributed assets. These asset "drop-downs" deprive existing lenders of a substantial source of value (the assets transferred to the unrestricted subsidiary), while allowing the company to raise new capital on the strength of those same assets.

Notably, because the borrower is relying on existing basket capacity under its credit documents, drop-down transactions can be completed without any prior amendment or consent of lenders.

As a result of these transactions, in some new financings, lenders have insisted on including "J. Crew blocker" language[78] prohibiting the contribution of material intellectual property (or, in some cases, other types of assets) to unrestricted subsidiaries. J. Crew blockers, however, are still far from market standard.

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[75] *See* Soma Biswas, *Deal to Save J. Crew from Bankruptcy Angers High-Yield Debt Investors*, WALL ST. J., Sept. 21, 2017, www.wsj.com/articles/deal-to-save-j-crew-from-bankruptcy-angers-high-yield-debt-investors-1506011065?st=nfwi4qvh53pt6jf&reflink=desktopwebshare_permalink.

[76] *See* Claire Boston & Katherine Doherty, *NYC Ferry's Hornblower Taps Niagara Falls Assets for Cash*, BLOOMBERG, Oct. 7, 2020, www.bloomberg.com/news/articles/2020-10-07/nyc-ferry-operator-gets-rescue-financing-from-niagara-transfer.

[77] *See* Andrew Scurria, *Travelport Owners Defy Lenders to Supply Up to $1 Billion Financing*, THE WALL ST. J. June 5, 2020, www.wsj.com/articles/travelport-owners-defy-lenders-to-supply-up-to-1-billion-financing-11591378563?st=ygooqes2y5t3o6b&reflink=desktopwebshare_permalink.

[78] *See* Paul Kilby, *J.Crew Blockers Take Fashionable Turn in Junk Bond Market*, IFR, June 12, 2020, www.ifre.com/story/2403209/jcrew-blockers-take-fashionable-turn-in-junk-bond-market-l8n2do5fa.

2. "Super Senior" Facilities

Another approach involves an exchange offer pursuant to which a subset of existing lenders agrees to exchange their existing debt for debt under a new, "super senior" facility, with liens or claims ranking senior to the existing debt that is not exchanged. The exchanging lenders may agree to exchange their existing debt for this super senior debt at a discount, and/or to provide "new money" under the super senior facility to bolster borrower liquidity. Non-participating lenders are "primed" by the super senior facility.

Unlike drop-down transactions, these types of transactions usually require the consent of a majority of the existing lenders. Specifically, the majority lenders agree to (1) permit the incurrence of the new super senior facility and (2) to subordinate the existing facility to that new super senior facility. As a reward for enabling the transaction, the consenting majority sees its overall credit position enhanced. Non-participating lenders, meanwhile, see their position correspondingly degraded.[79]

Non-participating lenders have challenged these transactions in court, arguing, among other things, that the transactions breached express or implied terms of the debt documents.[80] One recent high-profile dispute involved the mattress-maker Serta. In *Serta*, non-participating lenders sought to enjoin a transaction involving the issuance of approximately $1.1 billion in new super-priority 'first out' loans, to which the existing secured loans would be contractually subordinated pursuant to a new intercreditor agreement. A majority of original lenders consented to the incurrence of the new debt, which was then used to purchase $1.5 billion of existing

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[79] Similar discriminatory rights offerings have been approved in bankruptcy cases, described in Part III.C below.

[80] *See, e.g.*, Compl., *ICG Glob. Loan Fund 1 DAC* v. *Boardriders, Inc.*, No. 655175/2020 (N.Y. Sup. Ct. Oct. 9, 2020), http://iapps.courts.state.ny.us/nyscef/ViewDocument?docIndex=35GpuePXkWI/3Adzb26KZg== ("The Private Roll-Up Transaction unlawfully: (i) deprives the Non-Participating Lenders of their bargained-for first-lien priority and pro rata payment rights; (ii) subordinates their original first-lien debt in lien priority behind hundreds of millions of dollars of newly prioritized debt . . .; and (iii) leaves the Non-Participating Lenders with a stripped-down, covenant-bare promissory note for their original first-lien debt."); Compl., *Audax Credit Opps. Offshore, Ltd.* v. *TMK Hawk Parent Corp.*, No. 565123/2020 (N.Y. Sup. Ct. Nov. 7, 2020), https://iapps.courts.state.ny.us/nyscef/ViewDocument?docIndex=Wbjv/M62Gf_PLUS_EtLzUIOIULA== ("This breach-of-contract case arises from a cannibalistic assault by one group of lenders in a syndicate against another.").

loans owned by the consenting original lenders.[81] The plaintiffs (the holders of the primed debt) alleged that the transactions violated the loan documents, which they argued required unanimous consent of all lenders, and breached the implied covenant of good faith and fair dealing. The court declined to issue a preliminary injunction, finding that plaintiffs were not likely to succeed on either of their arguments, since the express terms of the credit agreement likely permitted such priming transactions.[82]

Yet, following the consummation of the transaction, a separate group of nonparticipating lenders brought suit against Serta in a different court, seeking damages for both express breach of contract and breaching the implied covenant of good faith and fair dealing. In a recent decision, that court denied Serta's motion to dismiss these claims, permitting the parties to move to trial.[83]

In the meantime, the market has had a chance to respond to the *Serta* fact pattern, which has recurred in other deals. In some new loan transactions, lenders have insisted on express language prohibiting amendments that would subordinate their liens without the consent of 100% of the lenders.[84]

3. Market Adaptation

The market response to these transactions is still evolving: It remains to be seen whether it will become common for lenders to seek to head off these transactions by requiring more restrictive credit documentation. So far, while some weaker borrowers have acceded to contractual limits on their flexibility, most borrowers—even highly leveraged ones—have not.

It will be interesting to see whether there is an increase in "lender cooperation" agreements, whereby early in a situation, a number of creditors agree not to seek

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[81] *See N. Star Debt Holdings, L.P.* v. *Serta Simmons Bedding, LLC*, 2020 WL 3411267 at *2 (N.Y. Sup. Ct. June 19, 2020).

[82] *See id.* at *4-6.

[83] *See* Opinion and Order, *LCM XXII Ltd.* v. *Serta Simmons Bedding, LLC*, No. 21-03987 (S.D.N.Y. Mar. 29, 2022), ECF No. 34.

[84] *See, e.g.*, Third Amendment, dated as of April 9, 2021, among Verint Systems Inc., JPMorgan Chase Bank, N.A. and the other parties party thereto, www.sec.gov/Archives/edgar/data/0001166388/000119312521111570/d133952dex101.htm; Second Amendment to Credit Agreement, dated as of March 31, 2021, among Empire State Realty Trust, Inc., Empire State Realty OP L.P., Wells Fargo Bank, National Association and the other parties party thereto, www.sec.gov/Archives/edgar/data/0001541401/000119312521103345/d284786dex101.htm.

transactions which benefit a bloc of lenders at the expense of other lenders in the same class. While this has occurred in some instances, the trend has generally been the opposite.

The prospect of such out-of-court "liability management" transactions represent a material threat to the position of investors that seek to take control of distressed companies by purchasing their loans and debt securities prior to bankruptcy and must be considered before investing.

D. Sales of Assets by Distressed Borrowers in Out-of-Court Transactions

A financially distressed company may attempt to sell assets or businesses for a variety of reasons, including to raise liquidity, pay down debt, and stave off bankruptcy. These transactions provide opportunities for the prospective purchaser, but they can also entail significant risks of which the purchaser should be aware.

1. Fraudulent Transfer Risks

Although the purpose of a transaction may be to stabilize a distressed seller, if it fails to do so and the company ultimately files bankruptcy, the purchaser could find itself the target of fraudulent transfer claims seeking to unwind transactions consummated prior to the filing.[85] Sales by severely distressed companies may be

[85] 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. 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 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.

In addition to the Bankruptcy Code, most states have fraudulent transfer 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, although as long as six years in other states such as Minnesota, Michigan and Maine). In addition, the IRS may avoid transfers made up to ten years earlier, and some courts have allowed the debtor "to step into the shoes of the IRS" and use its 10-year look-back period. *See, e.g.*, *In re Kaiser*, 525 B.R. 697 (Bankr. N.D. Ill. 2014) (permitting the trustee to invoke the IRS's 10-year look-back period); *Mukamal* v. *Citibank N.A. (In re Kipnis)*, 555 B.R. 877 (Bankr. S.D. Fla. 2016) (permitting the same and noting that "[o]nly one court has reached the opposite conclusion").

made under pressure, and often involve troubled assets for which potential bidders are wary of overpaying. As a result, distressed sales carry a risk of being challenged and potentially unwound on the basis that they were made either with an intent to hinder, delay or defraud creditors, or, more likely, for less than "reasonably equivalent value" by a seller found to have been insolvent at the time of, or rendered insolvent by, the sale. The closer to the bankruptcy filing and the more a sale appears to have been made under financial duress, the greater the probability of a successful challenge. For example, in *In re 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. A fraudulent transfer action brought by the bankruptcy trustee against the purchaser was ultimately settled for $25 million (thereby nearly doubling the initial purchase price of $28 million).[86] A successful fraudulent transfer challenge is not dependent on a finding of *balance sheet* insolvency of the distressed company; often the greater risk for a fraudulent transfer defendant is a determination, with the benefit of 20/20 hindsight, that the now-bankrupt company must have had "unreasonably small capital" at the time of the transaction.[87]

a. *Spin-offs and Other Intercompany Transactions*

Transfers of assets within a corporate group to the detriment of certain creditors can also be subject to fraudulent transfer challenges. The *ASARCO* case is an important example of this.[88] ASARCO sold its "crown jewel" asset—a controlling interest in a 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

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[86] *See Bridgeport Holdings, Inc. Liquidating Tr.* v. *Boyer (In re Bridgeport Holdings, Inc.)*, 388 B.R. 548, 553-58 (Bankr. D. Del. 2008). This case 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. *See id.*

[87] In *In re SemCrude, L.P.*, the U.S. Court of Appeals for 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. 648 F. App'x 205 (3d Cir. 2016). *See also Adelphia Recovery Tr.* v. *FPL Grp., Inc. (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 reasonably foreseeable future").

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

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. The court 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."[89] Even though AMC had paid reasonably equivalent value for the SPCC stock, the court ordered the transaction unwound and the SPCC stock returned to ASARCO.[90]

A related risk arises when a parent company (i) spins off a weak subsidiary, or (ii) spins off the healthy part of the business, and leaves the weaker or liability-burdened business behind, 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 be detrimental to the ability of legacy creditors to be paid, and hence constitute a fraudulent conveyance. The *Tronox* case illustrates this risk.[91] 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, renamed "Tronox," was spun off, and New Kerr-McGee, free of its legacy liabilities, was acquired by Anadarko Petroleum for $18.4 billion. Three years later, Tronox filed for bankruptcy and its creditors challenged the transaction as a fraudulent conveyance.

The *Tronox* court found that the transfer of the exploration business to New Kerr-McGee 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 recover in the future, would accordingly be 'hindered or delayed' as the direct consequence

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

[90] *Id.* at 364.

[91] *Tronox Inc*. v. *Kerr McGee Corp. (In re Tronox Inc.)*, 503 B.R. 239 (Bankr. S.D.N.Y. 2013).

of the scheme."[92] And even though Tronox was able to issue debt at the time of the spin-off and survived for three years thereafter, the transaction was also determined to be a "constructive" fraudulent conveyance because it occurred when the debtors had unreasonably small capital. 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.

Prior to *Tronox*, courts had become increasingly receptive to looking to contemporaneous market evidence of value to provide an 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.'"[93] 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 environmental and tort liabilities given 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."[94]

Tronox continues to represent an important warning about the risks of disproportionately allocating legacy liabilities to an entity that cannot support them. This becomes the problem of the purchaser, as it did for Anadarko. In structuring a transaction, several strategies can be helpful in mitigating the risks arising from a sale or spin-off of distressed assets, although none can eliminate the risks

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[92] *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).

[93] 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).

[94] 503 B.R. at 302-03.

completely. Most important, of course, is to ensure that the entity assuming, or being left with, significant liabilities can service them. Careful attention should be paid to making a record that there was an arm's-length disposition process that was conducted in good faith and resulted in reasonable terms. As part of that process, it may be helpful to obtain 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,[95] although courts do not always find such solvency opinions dispositive, particularly where the legacy liabilities are contingent or unliquidated, which is often the case with environmental or mass tort exposures. 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 of the legacy liabilities to Tronox's solvency."[96]

2. Other Risks to the Acquiror of Assets from a Distressed Company

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 attempt to "cherry-pick" among the different transaction agreements by rejecting some and assuming others.[97] 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.[98]

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[95] 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.

[96] *Tronox*, 503 B.R. at 287. There are certain exceptions to the general rule that the contract party's rights disappear terminate upon rejection, particularly in the intellectual property context. *See, e.g.*, *Mission Prod. Holdings, Inc.* v. *Tempnology, LLC*, 139 S. Ct. 1652 (2019) (holding that rejection of a trademark license agreement under section 365(g) does not terminate the rights of the licensee).

[97] *See* Part III.B.7 (discussing executory contracts).

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

Similar risks may exist when the company files for bankruptcy after the transaction closes. The company will have the ability to reject undesirable post-closing contracts, such as a transition services agreement, which can be particularly problematic if the buyer of the asset is relying on transition services from the seller for some period of time after the acquisition. Other post-closing obligations and indemnities from the seller can be rejected, leaving the buyer with prepetition unsecured claims for breach against the now-bankrupt seller, which may be severely impaired or even worthless. 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, explained in Part I.B.1.b.

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

Nevertheless, in many circumstances, the risks of dealing with a distressed seller out of court will simply be insurmountable as a commercial or legal matter. In those circumstances, the would-be buyer may employ a "wait and see" approach, keeping tabs on the financial position of the seller by monitoring its debt and equity prices, and talking to in-the-know advisors. Alternatively, it may attempt to persuade the target to enter bankruptcy, which alleviates most of these risks but involves its own complexities, as discussed in Part III.A below.

E. Sales of Equity and Equity-Linked Securities by Distressed Companies

A company facing distress may seek to raise emergency liquidity by selling equity or equity-linked securities. This section looks in particular at PIPEs ("private investments in public equity") and convertible notes issuances, each of which has been frequently employed by companies seeking emergency liquidity.

1. PIPEs

A "PIPE" investment, a private purchase of newly issued equity in a public company, can be of use to a distressed company, is often useful to a business that is facing a sudden liquidity crisis requiring prompt resolution, but which is

perceived by the market as being solvent over a long time horizon. The PIPE provides funding to bridge the immediate capital need for the company, and gives the investor an opportunity to buy stock at a perceived "low." Financial institutions made wide use of PIPEs in the financial crisis;[99] cruise and travel companies notably followed suit during the Covid-19 crisis.[100]

While each PIPE investment is unique and individually negotiated, an investor typically purchases new securities from the issuer at a discount to market. The investor may also receive governance rights, such as a right to designate one or more members of the issuer's board of directors. The issuance of securities in privately negotiated PIPE investments is not typically registered with the SEC (time being of the essence), so issuers often enter into registration right agreements committing to register the resale of 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"). PIPE investments may also, depending on the circumstances, require shareholder approval under applicable stock exchange rules or otherwise.

2. Convertible Notes

Convertible notes offer another possible liquidity solution for companies facing distress and another possible avenue for acquirors to obtain significant equity stakes. Convertible notes are debt instruments that provide holders with an embedded option to convert their notes into the issuer's common stock at a pre-specified conversion ratio at specific times during the life of the notes. At issuance, the conversion price of these notes typically exceeds the underlying value of the issuer's stock price (usually, by 20% to 30%) and therefore the conversion option is typically "out of the money" at that time. However, particularly where a company is facing short term headwinds that have impacted its stock price, convertible notes offer investors significant upside potential.

Like PIPEs, convertibles notes can be useful to companies that are facing immediate liquidity needs, but are perceived by investors to be long-term solvent.

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[99] *See, e.g.*, Eric Dash, *Bank is in Line for a $5 Billion Infusion*, N.Y. TIMES (Apr. 8, 2008), www.nytimes.com/2008/04/08/business/08bank.html.

[100] *See, e.g.*, Cara Lombardo & Dave Sebastian, *Expedia Names New CEO, Confirms Investment from Private-Equity Firms*, WALL ST. J., Apr. 23, 2020, www.wsj.com/articles/expedia-names-new-ceo-confirms-investment-from-private-equity-firms-11587648059.

Unlike PIPEs, however, convertible notes provide investors with a level of "downside protection" in the form of the debt claim, which provides ongoing interest payments and a claim for principal in a restructuring.

Convertible notes typically bear interest at lower rates compared to regular-way debt, since a portion of the compensation to the holder comes in the form of the embedded option. This lower interest rate feature can be particularly attractive to distressed companies looking to preserve cash. Convertible notes also generally contain few restrictions on issuers' operations and are consequently relatively quick to negotiate and execute, which can provide a significant advantage to struggling companies looking to secure liquidity on a short timeline. And because the conversation price of convertible notes is typically set at a substantial premium to market price, the dilution to existing stockholders is less than would be the case in connection with a straight equity offering. The market has also developed derivative products (including call-spread transactions and capped calls) to help companies further hedge this risk of dilution, though the benefits of such products should be closely scrutinized depending on the company's situation (in particular, they can be costly if the company is subsequently sold for cash).

Convertible notes also carry certain drawbacks, including (1) that as with any equity or equity-linked issuance, there may be a short-term impact on the stock price as a result of potential dilution and hedging activity by purchasers of the notes, (2) that the issuers' existing debt documents may treat these instruments in unexpected ways, including by restricting issuers' ability to make required payments on such instruments, treating certain events under the instruments as defaults under existing debt, or even prohibiting such instruments altogether, (3) substantial potential upfront cash costs of the hedging products, as well as their complex and somewhat opaque terms, which at their core give counterparties broad discretion (including calculating the costs of a potential unwind and, in certain circumstances, adjusting economics in the event of certain corporate transactions such as spin-offs or business combinations), and (4) potentially complex and significant tax implications.

F. Other Out-of-Court Transactions

1. Foreclosure Sales and Assignments for the Benefit of Creditors

a. *Foreclosure*

In certain circumstances, 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.

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 approach is to acquire the secured party's debt. Ownership of the debt obviously affords the investor greater control over the foreclosure process. It also enables the investor to credit bid, *i.e.*, use the debt as currency, at the foreclosure sale. Debt bought below par, even for pennies on the dollar, can generally be credit bid at its entire face amount, enabling the investor to bid substantially more than cash bidders in 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.D.1, 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."[101]

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 Enterprises, for example, which could not file for bankruptcy without significantly

[101] 511 U.S. 531, 545 (1994).

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 debt payment terms.

While dissenting lenders may be able to hold up strict foreclosures under certain debt documents, when there is sufficient consensus among creditor classes or relatively simple capital structures, out-of-court "strict foreclosure" transactions can be a nearly equivalent alternative to bankruptcy from a legal perspective, while saving months and millions of dollars. 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.[102] 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. In 2020, secured lenders to Philips Pet Food & Supplies deployed a similar structure to equitize their debt claims.[103]

In dealing with distressed companies with multi-layer ownership structures, foreclosure on equity interests can facilitate efforts to obtain control. For example, in the Marvel Entertainment Group bankruptcy case, affiliates of Carl Icahn temporarily obtained control over the debtors 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.[104] Similarly, 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

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

[103] *See, e.g.*, *CNH Diversified Opportunities Master Acct., L.P.* v. *Cleveland Unlimited*, 2020 WL 6163305 (N.Y. Ct. App. Oct. 22, 2020) (majority noteholders' purported cancellation of notes through strict foreclosure, without minority noteholders' consent, amounted to breach of indenture agreement and so did not extinguish minority noteholders' right to payment).

[104] *See In re Marvel Ent. Grp., Inc.*, 140 F.3d 463, 467 (3d Cir. 1998).

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.[105]

b. *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.

[105] *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 (Bankr. S.D.N.Y. Feb. 22, 2013), ECF No. 2071.

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.[106] In 2020, more than half of the chapter 11 plans confirmed by public companies with at least a billion dollars in assets were prepackaged or pre-negotiated.[107] And, according to one database, 29% of all large company chapter 11 cases filed 2021 were pre-negotiated, while 15% were prepackaged.[108]

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[106] 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), www.abi.org/node/269843.

[107] *See* Jones Day, *The Year in Bankruptcy: 2020* (Feb. 2021), www.jonesday.com/en/insights/2021/02/the-year-in-bankruptcy-2020.

[108] Data collected from Reorg Research's Restructuring Database and analyzed by Wachtell, Lipton, Rosen & Katz. *See* REORG RESEARCH RESTRUCTURING DATABASE, http://app.reorg.com/v3#/restructuring (last visited Apr. 19, 2022). According to another database, 16% of all chapter 11 plans filed between 2018 and 2020 were pre-negotiated, while 14% were prepackaged. Data collected from Debtwire's compilation of Restructuring Data and analyzed by Wachtell, Lipton,

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[109] and seek confirmation of that plan on the basis of votes solicited before the bankruptcy filing.[110] A committee of creditors established prior to a bankruptcy filing may continue to serve as the official creditors' committee in bankruptcy.[111]

Prepackaged plans (or "prepacks") have many advantages over "free fall" bankruptcy filings, particularly in complex and resource-heavy cases. 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 that stakeholders are informed, the promise of a short proceeding and the existence of a prepackaged plan may induce constituencies, such as trade creditors, to continue to do business with the company more or less as usual. Prepackaged plans can also be "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

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Rosen & Katz. *See* DEBTWIRE RESTRUCTURING DATA, www.debtwire.com/restructuringdb/cases/ (last visited Apr. 11, 2021).

[109] 11 U.S.C. § 1121(a).

[110] 11 U.S.C. § 1126(b). The prepetition solicitation must either comply with nonbankruptcy law regarding disclosures, if applicable, or meet the Bankruptcy Code's "adequate information" standard in section 1125(a). *See* Part II.A.2.

[111] 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.*

only two-thirds by dollar amount, and a majority in number, of the claims that vote in that class. *See* Part I.B.2.a.

Prepackaged plans are best suited for companies that are over-levered, rather than operationally flawed: The paradigmatic use of a prepackaged bankruptcy is when an out-of-court restructuring would be optimal, but the operative debt documents require unanimous consent to amend the economic terms of the debt. In such cases, bankruptcy law is needed to bind a minority of non-consenting creditors whose participation is necessary to complete a deal. For instance, in October 2019, Deluxe Entertainment Services, a video-services company, filed for bankruptcy with a prepackaged plan shortly after attempting an exchange offer. Even though every voting lender had approved the exchange offer, some lenders did not vote at all, necessitating the use of chapter 11 to implement the exchange.[112]

Prepackaged bankruptcies, by design, can move fast. In early 2019, retailer FullBeauty Brands Inc. completed its prepackaged bankruptcy in under 24 hours[113] and Sungard Availability Services Capital Inc. completed its prepack in 19 hours.[114] And numerous energy companies, including Superior Energy Services, Inc.[115] and MD America Energy, LLC,[116] have recently confirmed prepackaged plans in as little as two months. This speed can lead creditors and others to cry foul, however: In several cases, the U.S. Trustee's Office has objected

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[112] *See* Eric Chafetz & Myles R. MacDonald, *Ultra-Expedited Prepacks Are No Longer an Academic Curiosity*, 262 N.Y.L.J., No. 126 (Dec. 31, 2019), www.lowenstein.com/media/5419/20191230-new-york-law-journal-ultra-expedited-prepacks-are-no-longer-an-academic-curiosity-chafetz-macdonald.pdf.

[113] Soma Biswas, *Judge Approves FullBeauty's Record 24-Hour Bankruptcy Case*, WALL ST. J., Feb. 4, 2019, www.wsj.com/articles/fullbeauty-attempts-record-24-hour-bankruptcy-case-11549310368; *see also* Hugh McDonald & Alissa Piccione, *The Upside of the Fastest Chapter 11 Confirmation Ever* (July 2, 2019), www.lexology.com/library/detail.aspx?g=30f10bc4-e971-4fe8-bd96-8f224b297695.

[114] *See In re Sungard Availability Servs. Cap.*, No. 19-22915 (Bankr. S.D.N.Y.).

[115] *See* Dan Carino Jr., *Superior Energy Services Emerges from Chapter 11 Bankruptcy*, S&P GLOB. MKT. INTEL., Feb. 3, 2021, www.spglobal.com/marketintelligence/en/news-insights/blog/infographic-q4-20-us-power-forecast.

[116] *See* Press Release, MD America Energy, *MD America Energy Completes Financial Restructuring; Successfully Emerges from Chapter 11 with Strengthened Capital Structure and Enhanced Liquidity* (Dec. 24, 2020), www.prnewswire.com/news-releases/md-america-energy-completes-financial-restructuring-successfully-emerges-from-chapter-11-with-strengthened-capital-structure-and-enhanced-liquidity-301198468.html.

to these highly expedited prepackaged plans as giving insufficient notice to creditors.[117] In another recent case, the bankruptcy court confirmed and allowed a prepackaged chapter 11 plan to go effective within 24 hours of the petition date,[118] but simultaneously approved a "due process preservation order"[119] that allowed certain creditors time after the plan's effective date to opt out of plan releases and resolve disputes with the debtors regarding their claims. It remains to be seen whether bankruptcy courts will push back against rapid confirmation of prepackaged plans in the future or require the use of post-effective-date dispute resolution procedures.

Prepackaged plans have even been used to effect mergers. In May 2020, ESW Capital, LLC acquired BroadVision, Inc. pursuant to a prepackaged plan that BroadVision, Inc. had filed just two months earlier.[120]

Though prepackaged bankruptcies can achieve efficient debt restructurings, "traditional" bankruptcy typically affords greater opportunities to improve operational issues of the target company, 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

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[117] *See* Daniel Gill, *Federal Watchdog Wants to Put Brakes on High-Speed Bankruptcies,* BLOOMBERG LAW (Apr. 5, 2021), https://news.bloomberglaw.com/bankruptcy-law/federal-watchdog-wants-to-put-brakes-on-high-speed-bankruptcies.

[118] *See* Order Approving the Debtors' Disclosure Statement for, and Confirming, the Debtors' Joint Prepackaged Chapter 11 Plan, *In re Belk Inc.*, No. 21-30630 (Bankr. S.D. Tex. Feb. 24, 2021), ECF No. 61.

[119] *See* Due Process Preservation Order, *In re Belk Inc.*, No. 21-30630 (Bankr. S.D. Tex. Feb. 24, 2021), ECF No. 62.

[120] *See* Order Confirming the Amended Prepacked Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for BroadVision, Inc. at 1, *In re BroadVision, Inc.*, No. 20-10701 (Bankr. D. Del. May 15, 2020), ECF No. 135; *see also* Press Release, BroadVision, Inc., *BroadVision, Inc. Emerges from Chapter 11 with Confirmation of its Chapter 11 Plan of Reorganization* (May 15, 2020), www.globenewswire.com/news-release/2020/05/15/2034544/0/en/BroadVision-Inc-Emerges-from-Chapter-11-with-Confirmation-of-its-Chapter-11-Plan-of-Reorganization.html.

(creditors whose rights will be unaffected) as possible, since they will be deemed to have accepted the plan without the requirement of a vote.[121]

Relatedly, it is generally necessary to allow trade creditors to "ride through" in a prepackaged bankruptcy because it is difficult to implement a prepackaged plan in which such creditors are impaired. Unlike bondholders and other lenders, trade creditors are not represented by a single agent or trustee, making solicitation of their votes difficult without the aid of the procedures available under the Bankruptcy Code. Trade claims also fluctuate in amount 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, trade credit is likely to dry up during the pre-bankruptcy negotiation and solicitation period, 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-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]

Section 1126(b) of the Bankruptcy Code requires that pre-bankruptcy solicitations of votes on a chapter 11 plan either comply with applicable non-bankruptcy law or meet the requirements for disclosure statements that accompany a plan of

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[121] 11 U.S.C. § 1126(f).

[122] *See 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))).

reorganization in a conventional bankruptcy case. Rule 3018(b) of the Federal Rules of Bankruptcy Procedure additionally requires that a reasonable time be provided for such class members to vote after the materials used to solicit votes are provided to substantially all members of a class of claims or interests. 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.[124]

There has long been an unsettled question as to whether new securities offered under a prepack are exempt from the registration requirements of the Securities Act as they are in a conventional bankruptcy case pursuant to section 1145(a) of the Bankruptcy Code. Because the text of section 1145(a) exempts only a security "of the debtor" from registration, whereas the issuer technically is not a "debtor" until a chapter 11 proceeding is commenced, there is uncertainty about whether the exemption applies to a prepetition solicitation of votes for a prepack. The SEC staff has indicated in the past that the section 1145 exemption is not available for prepacks.[125] Debtors nonetheless regularly rely on the section 1145 exemption to issue new securities without registration under the Securities Act.[126]

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

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

[124] *See, e.g.*, Procedural Guidelines for Prepackaged Chapter 11 Cases in the United States Bankruptcy Court for the Southern District of New York § X.D (requiring official notice to be mailed to creditors at least 28 days prior to confirmation hearing unless shortened by the court), www.nysb.uscourts.gov/sites/default/files/3018-2-guidelines.pdf.

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

[126] *See, e.g.*, Disclosure Statement for the Joint Prepackage Plan of Reorganization of Sungard Availability Services Capital, Inc. and its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code, *In re Sungard Availability Services Capital, Inc.*, No. 19-22915 at *69 (Bankr. S.D.N.Y. 2019), ECF No. 16; Disclosure Statement for the Joint Prepackaged Chapter 11 Plan of Reorganization of FullBeauty Brands Holdings Corp. and its Debtor Affiliates Pursuant to Chapter 11 of the Bankruptcy Code, *In re FullBeauty Brands Holdings Corp.*, No. 19-22815 (Bankr. S.D.N.Y. 2019), ECF No. 14, *78; Disclosure Statement for the Prepackaged Plan of Reorganization Under Chapter 11 of the Bankruptcy Code for BroadVision, Inc., *In re BroadVision, Inc.*, No. 20-10701 (Bankr. D. Del. 2020), ECF No. 15, *32.

entities listed as owners with the indenture trustee) have authority to vote securities held in their name in connection with a bankruptcy plan.[127] As a result, it is 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

Pre-negotiated, as opposed to prepackaged, plans, have become increasingly common. Pre-negotiated plans have the advantage that they are not subject to bankruptcy court second guessing of the disclosure and solicitation process employed pre-bankruptcy which exists with prepacks. While pre-negotiated plans may necessitate a longer bankruptcy case because the solicitation and voting process occurs postpetition, financial market players have become increasingly tolerant of a company operating in bankruptcy. Moreover, given the minimum offer periods applicable to prepacks in the tender offer rules, pre-negotiated plans need not take much longer to consummate in the aggregate (once the prepetition time for notice is included) than prepackaged plans.

Because the disclosure statement and other solicitation procedures and materials are approved by the bankruptcy court prior to solicitation of votes on a pre-negotiated plan, the risk presented by a prepack that the solicitation could be found to be flawed after it occurs is eliminated. A disclosure statement is a document that is distributed to creditors that must provide "adequate information," including the terms of the proposed plan, and the debtor's prospects for fulling its obligations thereunder, to enable creditors and interest holders to vote.[128] 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

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[127] 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. 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.").

[128] Disclosure statements are discussed at greater length in Part III.B.2.a below.

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 include:

- minimizing negative publicity or reputational harm;
- minimizing judicial scrutiny and inquiry;
- lowering administrative expenses;
- avoiding a formal auction; 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 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 proposed transaction has the requisite support and at least some protection against being retraded.

However, a restructuring support agreement cannot provide a bidder with ironclad protection against its proposed transaction being renegotiated or even 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 that it will receive expense reimbursement if its bid is ultimately topped.

Prepetition restructuring support agreements can also 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.[129] The restructuring support agreements were essential to the completion of negotiations among the many competing constituencies of the two companies.[130] In addition, restructuring support agreements can be useful in curtailing the costs of bankruptcy. For example, such an agreement was instrumental in Neiman Marcus's rapid exit from bankruptcy in 2020,[131] and several of the largest bankruptcy filings of 2020, including those of fellow retailers JCPenney[132] and Guitar Center,[133] also involved prepetition restructuring support agreements.

Often restructuring support agreements contain commitments to provide new money in the form of a DIP, exit facility, or rights offering. The fees payable for backstopping that commitment can be quite significant, and the parties to the agreement may seek to exclude other, similarly situated parties, from that lucrative backstop role. Excluded creditors may challenge the backstop fees embedded in prepetition restructuring support agreements as treating similarly situated creditors inequitably and as unjustified uses of estate funds.[134] In *Peabody*, however, the

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[129] *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.*, No. 08-11467 (Bankr. D. Del. July 15, 2008), ECF No. 4 (describing prepackaged chapter 11 plans and merger).

[130] 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.

[131] *See* Press Release, Neiman Marcus Grp., *Neiman Marcus Group Enters into a Restructuring Support Agreement with a Significant Majority of its Creditors to Substantially Reduce Debt and Position the Company for Long-Term Growth* (May 7, 2020), https://apnews.com/press-release/pr-newswire/46e77fb6cd307768bf45a5228de76d6c.

[132] *See* Press Release, JCPenney, *JCPenney to Reduce Debt and Strengthen Financial Position through Restructuring Support Agreement* (May 15, 2020), www.businesswire.com/news/home/20200515005598/en/%C2%A0JCPenney-to-Reduce-Debt-and-Strengthen-Financial-Position-Through-Restructuring-Support-Agreement.

[133] *See* Alan Zimmerman, *Guitar Center in RSA to Reduce Debt By $800M, Get $165M in New Equity,* S&P GLOB. MKT. INTEL., Nov. 16, 2020, www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/guitar-center-in-rsa-to-reduce-debt-by-800m-get-165m-in-new-equity-61310945.

[134] *See, e.g.*, Objection [. . .] 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;

Eighth Circuit overruled such objections,[135] holding that the significant backstop fees available only to certain creditors who had engaged with the debtor were justified as consideration for valuable new commitments rather than on account of their prepetition claims.[136] *Peabody* and its implications are discussed in more detail in Part III.C of this outline.

Excluded creditors have also argued that prepetition restructuring support agreements 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. This objection that the agreement is a "*sub rosa* plan" is often made in varying contexts, rarely successfully.[137] *Sub rosa* plan objections are discussed at greater length in Part III.A.1.b, in connection with section 363 sales, the context in which they most often arise.

Restructuring support agreements can play an important role even if they are not ultimately approved by the bankruptcy court, by setting the baseline for structural and other issues in the reorganization. In the 2014 *Energy Future Holdings* bankruptcy, the debtors filed the case with a restructuring support agreement in place and sought bankruptcy court approval.[138] Although the debtor withdrew its request for court approval and terminated the agreement three months into the case when a better offer emerged,[139] the original restructuring support agreement set the basic framework for a tax-free restructuring that remained a consistent paradigm

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Objection [. . .] 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; 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] *In re Peabody Energy Corp.*, 933 F.3d 918 (8th Cir. 2019).

[136] *Id.*

[137] *See, e.g.*, *In re Empire Generating Co.*, 2020 WL 1330285, at *9-*11 (S.D.N.Y. Mar. 23, 2020).

[138] *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.

[139] *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; Alan Zimmerman, *Bankruptcy: As It Nixes Its RSA, Energy Future's Old, Vexing Issues Return*, S&P GLOB. MKT. INTEL., July 24, 2014, www.spglobal.com/marketintelligence/en/news-insights/latest-news-headlines/leveraged-loan-news/bankruptcy-as-it-nixes-its-rsa-energy-futures-old-vexing-issues-return.

for plan negotiations throughout the four-year life of the case.[140] Similarly, in 2020, Mallinckrodt filed for bankruptcy with a restructuring support agreement supported by several groups of creditors, but never sought court approval. Instead, throughout its case, additional parties joined the agreement, which formed the basis for Mallinckrodt's plan of reorganization.[141]

C. Pre-Negotiated Section 363 Sales

While the sale of all or a portion of a distressed company's assets under section 363 of the Bankruptcy Code must, by definition, occur once the company is in bankruptcy, stalking-horse bidders may be, and often are, lined up, and much of the spade work can be accomplished, prior to the bankruptcy filing. Although an acquisition agreement that is negotiated pre-bankruptcy will ultimately 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. By negotiating the transaction prior to the bankruptcy, 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. And distressed-company 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. The subject of stalking-horse bids is discussed in greater detail in Parts III.A.3 and III.A.5 of this outline.

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

[141] *See* Joint Plan of Reorganization [. . .], *In re Mallinckrodt PLC*, No. 20-12522 (Bankr. D. Del. Apr. 20, 2021), ECF No. 2074; *In re Mallinckrodt PLC*, 2022 WL 404323 (Bankr. D. Del. Feb. 8, 2022) (confirming Mallinckrodt's plan of reorganization).

III.

Acquisitions in Bankruptcy

A distressed company may attempt to sell itself, or all or substantially all of its assets, or shed select businesses or assets, through the bankruptcy process. This may be a particularly appealing strategy for companies that lack sufficient financial runway to orchestrate a pre-negotiated or prepackaged bankruptcy.

Such transactions 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, section 363 sales can be executed quickly. In contrast, a sale through a plan of reorganization is a more deliberate and time-consuming endeavor, requiring development of a plan, drafting and obtaining approval of a disclosure statement, soliciting votes on the plan, and confirming the plan with a court order.

This part of the 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

It has become relatively routine for significant asset sales to occur during large business bankruptcies. Approximately 51% of all chapter 11 cases filed in both 2018 and 2019 resulted in section 363 sales.[142] In 2020 and 2021, that number declined to 39% and 40%, respectively, but was still a significant slice of overall bankruptcy activity during a period marked by pandemic-related filings.[143]

There are several reasons for this increase in chapter 11 cases involving significant asset sales since the Bankruptcy Code's enactment in 1978. Hedge funds, which now hold a dominant place among debtholders, are typically more interested in, and structurally suited for, quick sales of the debtor rather than long-term

[142] Data for 2018 to 2020 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 April 11, 2021). Data for 2021 collected from Reorg Research's Restructuring Database and analyzed by Wachtell, Lipton, Rosen & Katz. *See* REORG RESTRUCTURING DATABASE, http://app.reorg.com/v3#/restructuring (last visited April 19, 2022).

[143] While only time will tell, this reduction may reflect the extraordinary economic conditions resulting from the global pandemic and the subsequent flood of retail liquidations rather than a durable shift in the dynamics of chapter 11 cases.

restructurings. Strategic and financial purchasers have also become increasingly sophisticated and less concerned about the "taint" of bankruptcy on the debtor's assets. And, as a general matter, parties are mindful of the high costs of protracted bankruptcy proceedings and their potential to destroy value for all parties.

Potential buyers no doubt also appreciate a process that allows them to add EBITDA-accretive or otherwise synergistic assets to their existing business portfolios quickly, while debtors can utilize section 363 of the Bankruptcy Code to rationalize their remaining businesses or effectively liquidate, in each case, through an inherently competitive process that is geared to maximizing returns for the estate's interest holders.

1. Overview of Section 363 of the Bankruptcy Code

Section 363 of the Bankruptcy Code authorizes a trustee or a debtor to sell some or all 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 bankruptcy court approval.[144] 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.[145]

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."[146] 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.

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[144] *See* 11 U.S.C. § 363(c)(1).

[145] *See* 11 U.S.C. § 363(b)(1).

[146] *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); *Cello Bag Co.* v. *Champion Int'l Corp. (In re Atlanta Packaging Prods.), Inc.*, 99 B.R. 124, 131 (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,[147] 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.[148]

It is safe to say that those days are gone: 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."[149]

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[147] *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 . . . is heightened").

[148] 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.").

[149] The standard for approval was first 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. Specifically, in *Lionel*, the court suggested that

Debtors in certain industries may be more likely to use section 363 to sell substantially all of their assets. In retail cases, where 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.[150] For a retail debtor, any significant delay can result in a decline in operating revenues, loss of 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.[151] The same justifications, as well as the limited duration of patent rights, have been employed in pharmaceutical company bankruptcies.[152] Financial firms have also been sold quickly via section 363, with rapidly deteriorating enterprise value serving as justification for the sale. In perhaps the most dramatic example,

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judges look to relevant factors such as "the proportionate value of the asset to the estate as a whole, the amount of elapsed time since the filing, the likelihood that a plan of reorganization will be proposed and confirmed in the near future, the effect of the proposed disposition on future plans of reorganization, the proceeds to be obtained from the disposition vis-a-vis any appraisals of the property, which of the alternatives of use, sale or lease the proposal envisions and, most importantly perhaps, whether the asset is increasing or decreasing in value." *Id.* at 1071; *see also In re Bos. Generating, LLC*, 440 B.R. 302, 329 (Bankr. S.D.N.Y. 2010) (although the debtors might not "die on the operating table" if the sale were deferred, the court approved an immediate sale over the junior lenders' objection that the company would fetch a higher price in the future).

[150] *See, e.g.*, Retail Insight Network, *Francesca's Completes Sale of All Assets, Inventory and Brand*, Feb. 2, 2021, www.retail-insight-network.com/news/francescas-sale-inventory-brand (less than two months between petition date and sale); Vicki M. Young, *Nine West, Bandolino Brands Sold to ABG for $340 Million*, WWD, June 11, 2018, wwd.com/fashion-news/fashion-scoops/nine-west-bandolino-brands-sold-to-abg-authentic-brands-group-bankruptcy-340m-1202702786 (about 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), 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).

[151] *See, e.g.*, Aisha Al-Muslim, *Bankrupt Ann Taylor Owner Gets Green Light for Sale Despite DOJ Objection*, WALL ST. J., Dec. 8, 2020, www.wsj.com/articles/bankrupt-ann-taylor-owner-gets-green-light-for-sale-despite-doj-objection-11607470470; Sapna Maheshwari, *Bankrupt Brooks Brothers Finds a Buyer*, N.Y. TIMES, Aug. 12, 2020, www.nytimes.com/2020/08/12/business/brooks-brothers-sale-authentic-brands.html.

[152] *See* Debtors' Omnibus Reply to Objections to the Debtors' Motion for (I) an Order (A) Approving the Bidding Procedures for the Sale of Substantially All of the Debtors' Assets [. . .], *In re Synergy Pharm., Inc.*, No. 18-14010 (Bankr. S.D.N.Y. Jan. 2, 2019), ECF 149 ¶¶ 16-18; Declaration [. . .] in Support of Entry of the Bidding Procedures Order, *In re Synergy Pharm., Inc.*, No. 18-14010 (Bankr. S.D.N.Y. Jan. 2, 2019), ECF 151 at ¶¶ 22, 24.

Lehman Brothers was permitted to sell its multibillion dollar broker-dealer business within days of its chapter 11 filing because the value of the business was rapidly eroding due to customer and counterparty defections.[153]

(ii) Robust Auction

While section 363 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."[154] A proposed sale may be disapproved if the court finds that the debtor did not conduct a robust sale process.[155] Conversely, a court will be more likely to conclude 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 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 in the marketplace is the best indicator of enterprise value."[156] Courts generally adopt this approach, deferring to auction results as an indicator of market value where the court is satisfied that the auction process was sound.[157] If a sale is to an insider of the debtor, however, the court will usually impose a greater level of scrutiny on the sale procedures and the price.[158]

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[153] 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).

[154] *In re Trans World Airlines, Inc.*, 2001 WL 1820326, at *4 (Bankr. D. Del. Apr. 2, 2001).

[155] *In re Exaeris, Inc.*, 380 B.R. 741, 744-47 (Bankr. D. Del. 2008) (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).

[156] *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").

[157] *See In re Pursuit Cap. Mgmt., LLC*, 874 F.3d 124, 136 (3d Cir. 2017) ("[W]e have said that 'a public auction, as opposed to appraisals and other evidence, is the best possible determinant of […] value.'" (quoting *Abbotts Dairies*, 788 F.2d at 149)).

[158] *See In re Flour City Bagels, LLC*, 557 B.R. 53 (Bankr. W.D.N.Y. 2016) (proposed sales to insiders must face higher scrutiny); *In re Fam. Christian, LLC*, 533 B.R. 600, 626 (Bankr. W.D.

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. The process is described further in Parts III.A.1.a.ii and III.A.2.b.i below.

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 emerges. Therefore, it is 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 official creditors' committee to demand an oversight 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 be challenged on the basis that 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, which does not impose such requirements, cannot serve as a substitute for a chapter 11 plan.[159] Accordingly, an element in 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.[160]

The *sub rosa* plan objection has been ubiquitous in bankruptcy litigation, but it is not often successful. Some bankruptcy courts have even attempted to curtail such

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Mich. 2015) (denying sale motion because certain flaws in the auction process "cannot be ignored in light of the heightened scrutiny applied to insider transactions"). *See also* Part III.A.1.c.

[159] 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.

[160] *See In re Braniff Airways*, 700 F.2d 935 (5th Cir. 1983); *In re Gulf Coast Oil Corp.*, 404 B.R. 407 (Bankr. S.D. Tex. 2009).

objections by imposing local rules that require the objector to specify in detail the protections that they would have in the context of confirming a plan of reorganization that would be denied to them by the proposed asset sale.[161] 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.[162]

c. *The "Good Faith" Requirement*

While there is no express requirement in section 363 that the court find the purchaser acted in good faith, some courts have concluded that a good faith finding is a necessary part of a sale order.[163] Even in jurisdictions where a good-faith finding is not required under the caselaw, 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.[164] Section 363(m) thus significantly

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[161] *See Procedures for Complex Cases in Southern District of Texas* ¶ 30 (Oct. 19, 2020), www.txs.uscourts.gov/sites/txs/files/Complex%20Procedures%20for%20Chapter%2011%20Cases%20in%20the%20Southern%20District%20of%20Texas%2010-19-2020.pdf.

[162] *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."); *see also In re 9 Hous. LLC*, 578 B.R. 600, 620-21 (Bankr. S.D. Tex. 2017).

[163] *See Abbotts Dairies*, 788 F.2d at 149-150 ("[W]hen a bankruptcy court authorizes a sale of assets pursuant to section 363(b)(1), it is required to make a finding with respect to the 'good faith' of the purchaser."); *Factory Mut. Ins. Co.* v. *Panda Energy Int'l, Inc. (In re Hereford Biofuels, L.P.)*, 466 B.R. 841, 860 (Bankr. N.D. Tex. 2012) (agreeing with *Abbotts Dairies*). *But see In re Tresha-Mob, LLC*, 2019 WL 1785431 (Bankr. W.D. Tex. Apr. 3, 2019) ("stop[ping] short of adopting a per se 'good faith' prerequisite").

[164] 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

limits appellate review of a consummated sale, helping to maximize the sale price by ensuring finality to bidders.[165] This is discussed further in Part III.A.2.a.iii.A below.

Courts generally apply a heightened standard of review to transactions in which a proposed purchaser is an insider or fiduciary of the debtor.[166] In this context, the "good faith" analysis focuses primarily on whether an insider has received any special treatment in connection with the section 363 sale.[167] In any case where a section 363 sale involves an insider, best practice is to disclose fully to the court and creditors the relationship (if any) 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.

A recent example where an insider who was both management and equity demonstrated its good faith and prevailed on a bid occurred in the *Sears Holdings Corporation* chapter 11 case. There, the Bankruptcy Court for the Southern District of New York approved a sale of most of the company's 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.[168] The court held that a formal auction was not required, but that an inquiry into the sale process was

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appeal, the sale order is 'statutorily moot' on appeal as to all issues other than whether the buyer purchased the assets in good faith.").

[165] *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 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).

[166] If the debtor is a corporation, the Bankruptcy Code defines an "insider" as including (but not limited to) 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).

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

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

"clearly warranted, especially where the sale is to an insider."[169] 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 having been replaced by an independent committee of the Board represented by independent counsel and financial advisors.[170] 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."[171]

By contrast, there have been numerous instances where bids from insiders have been rejected because of an inability to demonstrate good faith.

For example, in *In re Abbotts Dairies of Pennsylvania*,[172] 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" 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. The Third Circuit also found that the allegations made by the objectors would, if proven, constitute collusion with an insider and would be inconsistent with a finding of good faith.[173]

Similarly, in *In re Bidermann Industries U.S.A., Inc.*,[174] the bankruptcy court rejected a proposed leveraged buyout of the debtor for lack of good faith due to

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[169] *Id.* at 217.

[170] *Id.* at 225-26. 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.

[171] *Id.* at 230.

[172] 788 F.2d 143 (3d Cir. 1986).

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

[174] 203 B.R. 547 (Bankr. S.D.N.Y. 1997).

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 board.[175] 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."[176] 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."[177]

In *In re Family Christian*,[178] the court also refused to approve a sale to an insider, focusing in part on a telephone call from the debtors' CEO to the winning bidder during the second night of the auction. The court viewed the debtor's CEO contacting a bidder outside of the formal auction process, particularly where the insider had assured him of future employment, as undercutting the auction's fairness.

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.[179] 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."[180] It also permits

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

[176] *Id.* at 551.

[177] *Id.* at 553.

[178] 533 B.R. 600 (Bankr. W.D. Mich. 2015).

[179] *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).

[180] 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

an approved sale to be avoided, or for damages to be obtained from a bidder, if a collusive agreement among bidders deprived the estate of value.[181] Finally, if the purchaser acted in willful disregard of section 363(n), the court can order punitive damages. While no reported decision has done so to date, 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.[182] 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.[183] 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.[184]

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 or 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. The 2011 sale of Nortel Network's portfolio of over 6,000 mobile telecommunications patents through a section 363 sale remains the prime example of the potential benefit to the estate of collaborative

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agreement inferred from the behavior of the parties or the circumstances."), *leave to appeal denied*, 425 B.R. 284 (W.D. La. 2010).

[181] *See id.*; *see also Licensing by Paolo, Inc.* v. *Sinatra (In re Gucci)*, 126 F.3d 380, 391 (2d Cir. 1997); *Gumport* v. *China Int'l Tr. & Inv. Corp. (In re Intermagnetics Am., Inc.)*, 926 F.2d 912, 917 (9th Cir. 1991).

[182] *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).

[183] *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).

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

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 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.[185] 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.[186]

Bidding groups have also emerged in recent retail bankruptcies, often pairing store liquidators with buyers of a retailer's intellectual property. For example, in 2016, a consortium of fashion brand licensing companies, retail real estate companies and liquidators prevailed in a bankruptcy auction for Aéropostale.[187] And in 2020, Authentic Brands Group, Simon Property Group and Brookfield Property Partners—all of which were in the consortium that purchased Aéropostale—teamed up again to purchase Forever 21 Inc. and J.C. Penney through section 363 sales.[188]

As there are 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. Generally, the practice is to make disclosures to the debtor, secured lenders, and the official creditors' committee, and not to the court (although the

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

[186] *See* Peg Brickley, *Nortel $4.5-Billion Patent Sale to Apple, Microsoft, Others Approved*, WALL ST. J., July 11, 2011, www.wsj.com/articles/SB10001424052702303812104576440161959082234.

[187] Jessica DiNapoli, *Consortium's $243.3 Million Bid Wins Aeropostale Auction*, REUTERS, Sept. 1, 2016, www.reuters.com/article/us-aeropostale-m-a-authenticbrands/consortiums-243-3-million-bid-wins-aeropostale-auction-idUSKCN1180AC.

[188] Merrit Kennedy, *Forever 21 Filed for Bankruptcy But Will Live on with New Owners*, NPR, Feb. 20, 2020, www.npr.org/2020/02/20/807755366/forever-21-filed-for-bankruptcy-but-will-live-on-with-new-owners; Anne D'Innocenzio, *U.S. Bankruptcy Court Approves Sale of J.C. Penney*, ABC NEWS, Nov. 10, 2020, http://abcnews.go.com/Business/wireStory/us-bankruptcy-court-approves-sales-jc-penney-74130069.

better practice might be to do so).[189] 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.[190] 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.[191] 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.

2. Benefits and Risks of Using Section 363

a. *Benefits of Using Section 363*

(i) Speed

Plan confirmation (even if uncontested) is a complex process that generally requires a significant amount of time. By contrast, a section 363 sale is designed to be consummated much faster.

If a distressed company has the financial runway, one common approach is to negotiate a sale with a stalking-horse bidder outside of bankruptcy and file with a

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[189] *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.").

[190] *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).

[191] *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.

stalking-horse bid and a set of bidding procedures in hand. Conducting the initial auction process pre-filing can reduce the length and expense of the bankruptcy case.

Upon filing, the company will seek approval of the bidding procedures, commence a postpetition marketing effort and, if necessary, conduct a second auction to determine the highest and best bid. Generally, the stalking-horse bidder has a right to terminate its asset purchase agreement if a court order approving bidding procedures and setting an auction date is not entered shortly after the bankruptcy case commences. A typical period of time from filing to approval of the bidding procedures is 20 to 30 days,[192] with postpetition marketing commencing immediately after approval and lasting 25 to 75 days.[193] 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.[194] However, a robust pre-bankruptcy marketing process may enable the debtor to expedite the sale process in court. For example, the Weinstein Company filed for bankruptcy on March 19, 2018 with a stalking-horse agreement with Lantern Capital already signed.[195] Bidding procedures were approved on April 6, 2018,[196] with a bid deadline of May 1, 2018, less than a month later. The winning bidder was the stalking horse, whose bid was approved on May 8, 2018.[197] Thus, from

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[192] The bankruptcy court will likely insist that the timeline allow for the appointment of the official unsecured creditors' committee and such committee's review of the bidding procedures.

[193] Even where a robust pre-bankruptcy marketing process has occurred, it is customary for the postpetition marketing process to last at least 25 days to ascertain if there are any other bids forthcoming.

[194] *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").

[195] *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.

[196] *See* Order . . . 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.

[197] *See* Order . . . 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.

start to finish, The Weinstein Company sold substantially all of its assets in bankruptcy in 50 days.[198]

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 pre-filing marketing process 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 leave behind unwanted contracts or operations. Additional diligence into whether these opportunities could increase the asset's value may be necessary to determine a final bidding price. A buyer also must stand ready to analyze, and potentially object to, proposed auction procedures, and to garner the support of key constituents, all on an expedited timeline.

(ii) Ability to "Cherry-Pick" Assets

A purchaser under section 363 of substantially all or a portion of a debtor's assets is often given the flexibility to cherry-pick from among the debtor's assets for a specified period of time, sometimes extending 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 cherry-picking can be of any type, but they 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.7 of this outline). Typically, the buyer will direct which "executory" contracts and leases will be assumed and assigned

[198] Bausch Health completed its acquisition of substantially all of Synergy Pharmaceuticals' assets in a section 363 sale that was approved 60 days after Synergy's filing. *See In re Synergy Pharm., Inc.*, No. 18-14010 (Bankr. S.D.N.Y. Mar. 3, 2019), ECF No. 484.

following the sale.[199] 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.[200]

Another form of cherry-picking that has been permitted in retail bankruptcies is the sale of "designation rights."[201] 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.

One economic issue that may be negotiated in the course of selecting assets is whether the debtor or the buyer will pay the costs of curing any defaults under the leases and contracts that are to be assigned to it post-closing, or 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 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

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[199] *See, e.g.*, *In re United Retail Grp., Inc.*, No. 12-10405 (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).

[200] 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. Similarly, in retail cases, it has become common to use the power of rejection to renegotiate real estate leases, discussed further in Part III.B.7 below. *See also* Aisha Al-Muslim, *Retail Tenants Leverage Pandemic Stress for Rent Cuts*, WALL ST. J., Jan. 11, 2021, www.wsj.com/articles/retail-tenants-leverage-pandemic-stress-for-rent-cuts-11610361000.

[201] *See, e.g.*, Order at Ex. A ¶ X, *In re Ascena Retail Grp., Inc.*, No. 20-33113 (Bankr. E.D. Va. Dec. 12, 2020), ECF No. 1292 ("Such modification rights include . . . the right of the Buyer, prior to the applicable Designation Deadline, to designate an Assigned Contract for assumption by the Debtors and assignment to the Buyer or one or more of the Buyer Designees."); Order Approving Asset Purchase Agreement, *In re Brooks Bros. Grp., Inc.*, No. 20-11785 (Bankr. D. Del. Aug. 14, 2020), ECF No. 444.

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. A buyer may also negotiate to deduct certain cure costs from the purchase price, as was done in Bausch's acquisition of Synergy Pharmaceuticals.[202]

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 above 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 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 rejection of contracts or leases because of the damages claims that would be created and share in their recovery.

(iii) Protections that Can Be Obtained from Bankruptcy Court's Sale 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 obtains a stay pending appeal. Stays are difficult to obtain, and even if granted require posting 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

[202] *See* Order Approving Sale of Substantially All of the Debtors' Assets, *In re Synergy Pharm., Inc.*, No. 18-14010 (Bankr. S.D.N.Y. Mar. 1, 2019), ECF No. 484 (setting a purchase price of $185 million minus the "Cure Costs Deduction").

hearing and that the court make an explicit finding of good faith in its sale approval order.

Courts have generally interpreted section 363(m) broadly to preclude reversal or modification on appeal of nearly all aspects of the sale order.[203] 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."[204] The Third Circuit, which includes Delaware, has similarly construed the scope of the sale order subject to section 363(m)'s protection against reversal broadly in order to "promote the finality of sales."[205]

Section 363(m)'s protection has been construed in some circuits to be broad enough to amount to an absolute jurisdictional bar against appellate review of a sale order by *any* party.[206] In others, section 363(m) has been described as a defense that can

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[203] *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*]. . . ."); *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) (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*).

[204] *In re WestPoint Stevens, Inc.*, 600 F.3d 231, 248-49 (2d Cir. 2010); *see also, e.g.*, *MOAC Mall Holdings, LLC* v. *Transform Holdco, LLC (In re Sears Holdings Corp.)*, 2021 WL 5986997 (2d Cir. Dec. 17, 2021) (section 363(m) deprived appellate court of jurisdiction to overturn the sale), *petition for cert. filed*, No. 21-1270 (Mar. 21, 2022); *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); *cf. Trinity 83 Dev., LLC* v. *ColFin Midwest Funding, LLC*, 917 F.3d 599 (7th Cir. 2019) (holding that a challenge to the disposition of sale proceeds was not barred by section 363(m)).

[205] *In re Pursuit Cap. Mgmt.*, 874 F.3d 124, 133-34, 139 (3d Cir. 2017); *see also Nashville Senior Living,* 407 B.R. at 231.

[206] *See WestPoint Stevens*, 600 F.3d at 250-51; *Cargill, Inc.* v. *Charter Int'l Oil Co. (In re The Charter Co.)*, 829 F.2d 1054, 1056 (11th Cir. 1987) (appeal dismissed under section 363(m) even though purchaser was the party seeking to appeal because § 363(m) "states a flat rule governing *all*

be invoked on appeal, rather than a jurisdictional limit on the court's reviewing power.[207] Although these are theoretically distinct interpretations, in practice, a purchaser can obtain nearly ironclad protection against reversal provided that the appropriate good faith findings are obtained.

A powerful demonstration of section 363(m)'s jurisdictional implications is *MOAC Mall Holdings LLC* v. *Transform Holdco LLC (In re Sears Holdings Co.)*.[208] There, the bankruptcy court approved a sale of substantially all of Sears' assets under section 363, including the right to seek to assume and assign some of Sears' store leases. In one of these subsequent assumption and assignment proceedings, the purchaser successfully assumed and assigned a lease over an objection that the purchaser's financial condition and operating performance was inadequate to give "adequate assurance of future performance" as required for shopping center leases under the Bankruptcy Code. The landlord sought a stay of the bankruptcy court's order assigning the lease, which was denied, after the purchaser apparently waived any defense based on section 363(m). On appeal, the district court agreed with the landlord and reversed the bankruptcy court's order approving the assignment.[209] The purchaser then sought reconsideration of the district court's order, arguing that section 363(m) covered the assignment of the lease, and that as a result, the district court lacked jurisdiction to hear the appeal.[210] The district court agreed, vacated its previous order, and effectively reinstated the assignment. The Second Circuit affirmed the ruling that the purchaser could not waive section 363(m)'s jurisdictional limitation.[211] As of this writing, the landlord's petition for a writ of certiorari to the U.S. Supreme Court is pending.

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appeals of section 363 authorizations" (emphasis added)); *see generally In re Energy Future Holdings Corp.*, 949 F.3d 806, 820 (3d Cir. 2020) ("In many circuits . . . § 363(m) is read essentially as a jurisdictional bar against any appeal of an unstayed sale order.").

[207] *See Trinity 83 Dev., LLC*, 917 F.3d at 603; *Reynolds* v. *ServisFirst Bank (In re Stanford)*, 17 F.4th 116, 122 (11th Cir. 2021) ("Though it provides a defense against appeals from bankruptcy court orders, 'even an ironclad defense, does not defeat jurisdiction.'" (quoting *Trinity 83 Dev., LLC*, 917 F.3d at 602)).

[208] 616 B.R. 615 (S.D.N.Y. 2020), *aff'd*, 2021 WL 5986997 (2d Cir. Dec. 17, 2021).

[209] *In re Sears Holdings Corp.*, 613 B.R. 51 (S.D.N.Y. 2020), *vacated on reconsideration*, 616 B.R. at 634.

[210] 616 B.R. at 618.

[211] 2021 WL 5986997.

In sum, purchasers in a section 363 sale should obtain an explicit section 363(m) finding in the bankruptcy court's order approving the sale, preferably after making an evidentiary record to support the finding.[212]

(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.D.1 of this outline.

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

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 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 by operation of law—so-called "successor liability."

When drafting an asset purchase agreement and proposed court order that will govern and approve a purchase of assets from a seller in bankruptcy, 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,

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[212] *See Crowder* v. *Given (In re Crowder)*, 314 B.R. 445, 447 (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 Fitzgerald* v. *Ninn Worx Sr., Inc. (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 Cap. 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).").

overbreadth in drafting can result in unexpected liabilities, even where the court is otherwise willing to limit the purchaser's liability.[213] While a sale in bankruptcy does not *per se* bar the assertion against an asset purchaser of any and all claims against the seller,[214] it does offer substantial protection for a buyer from involuntarily becoming responsible for the seller's liabilities. Specifically, under the circumstances outlined therein, section 363(f) permits the acquisition of property from the debtor "free and clear of any interest in such property" and relegates holders of "interests" to a recovery from the sale proceeds. Thus, section 363 is structured to encourage nervous bidders to purchase assets in bankruptcy.[215]

(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

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[213] *See, e.g.*, *Am. Airlines, Inc.* 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 under terms of acquisition agreement and sale order). Failure to include language specifically releasing the purchaser from certain claims can similarly result in unexpected liabilities.

[214] 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.*, 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. 778 F.2d 533, 538 (9th Cir. 1985). Likewise, in *Esopus Creek Value LP* v. *Hauf*, 913 A.2d 593 (Del. Ch. 2006), 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. *Id.* at 604-05.

[215] *See Olson* v. *Frederico (In re Grumman Olson Indus., Inc.)*, 445 B.R. 243, 249 (Bankr. S.D.N.Y. 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)).

secured claims, but also other kinds of claims, such as general unsecured claims with a connection to the acquired property.[216]

In re Trans World Airlines, Inc.[217] 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. In that case, the court ruled that assets of the debtor can be sold free and clear of general unsecured claims attributable to the prior use of those assets, as opposed to just *in rem* interests such as liens.[218] This interpretation enables a broad spectrum of unsecured claims to be barred, so that a well-drafted sale order can protect the buyer from nearly all claims against the seller that the buyer has not agreed to assume.[219] This interpretation has been accepted by most courts,[220] including the Second Circuit and the Delaware bankruptcy courts.

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[216] By contrast, as discussed in Part III.B.3 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* (in contrast to interests) and therefore could result in broader protection from liabilities. *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) (tort claims were not barred against asset purchaser by virtue of purchase because they did not constitute "interests," but they were barred by 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.") (citation omitted); *In re Trans World Airlines, Inc.*, 322 F.3d 283, 288-89 (3d Cir. 2003) ("Some courts 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.'").

[217] 322 F.3d 283 (3d Cir. 2003).

[218] The Third Circuit ruled that TWA's assets could be sold free from (a) the terms of a prepetition settlement requiring travel vouchers for certain employees and (b) certain unliquidated claims held by the Equal Employment Opportunity Commission, both of which it deemed to be "interests in property" as required by section 363(f). *See id.* at 290-91; *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 Riverside Acquisition Grp. LLC* v. *Vertis Holdings, Inc. (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).

[219] *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).

[220] 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

(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 may present traps for the unwary in any particular case. Consequently, any sale likely to implicate "interests" in or claims relating to the assets requires careful assessment of how section 363(f) can be satisfied.

Section 363(f)(1) permits the debtor 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 real property law[221] or section 9-320(a) of the 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" because local real property law typically does not permit the sale of property free and clear of such covenants,[222] though it may still be sold subject to the covenant. Such covenants

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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), *vacated as moot*, *Ind. State Police Pension Tr.* 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").

[221] *See, e.g.*, *Rose* v. *Carlson (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. 2018) (denying sale free and clear because debtor failed to show that state law would have allowed such a sale).

[222] *See, e.g.*, *Newco Energy* v. *EnergyTec Inc. (In re EnergyTec, Inc.)*, 739 F.3d 215 (5th Cir. 2013).

are often implicated in the oil and gas industry under agreements such as joint operating, gathering, and participation agreements.[223]

Section 363(f)(2) allows the debtor 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. In the context of a first-/second-lien capital structure, it is common for an intercreditor agreement to provide for the junior creditors' consent in advance to such transactions so long as the senior creditors actually consent. 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 generally bind individual lienholders that oppose the sale.[224]

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. The critical issue this raises is what is the value of a lien. 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.[225] Many courts have

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[223] Similar issues arrive in the section 365 context, where a debtor is seeking to reject a contract and the counterparty argues that the contract involves a covenant running with the land. *Compare Sabine Oil & Gas Corp.* v. *HPIP Gonzales Holdings, LLC (In re Sabine Oil & Gas Corp.)*, 550 B.R. 59 (Bankr. S.D.N.Y. 2016) (midstream gas gathering agreements did not create covenants running with the land and could therefore be rejected by the debtor during bankruptcy), *aff'd*, 567 B.R. 59 (Bankr. S.D.N.Y. 2016), *aff'd*, 567 B.R. 869 (S.D.N.Y. 2017), *aff'd*, 734 F. App'x. 64 (2d Cir. 2018) *with Monarch Midstream, LLC* v. *Badlands Prod. Co. (In re Badlands Energy, Inc.)*, 608 B.R. 854 (Bankr. D. Colo. 2019) (gathering and salt water disposal agreements created covenants running with the land that were immune from rejection) *and Alta Mesa Holdings, LP* v. *Kingfisher Midstream, LLC (In re Alta Mesa Res., Inc.)*, 613 B.R. 90, 100 (Bankr. S.D. Tex. 2019) (same).

[224] *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).

[225] *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 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

defined "value" as the face value of all claims means that collateral cannot be sold free and clear under section 363(f)(3) unless lienholders are paid in full.[226] Others, though, have interpreted section 363(f)(3) as referring to the economic value of the liens, which allows sales to go forward even though creditors with liens on the assets are not paid in full.[227]

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 over the interest holder's objection when what is disputed does not concern the fundamental validity of a lien or interest, or whether the property truly belongs to the estate,[228] but rather concerns tangential matters, such as the validity of covenants or the distribution of sale proceeds.[229]

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." Its most straightforward application is selling

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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.").

[226] *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); *In re Lutz*, 2017 WL 3316046 (Bankr. D. N.J. May 3, 2017); *In re Canonigo*, 276 B.R. 257 (Bankr. N.D. Cal. 2002).

[227] *See, e.g.*, *In re Bos. Generating*, 440 B.R. at 332-33 ("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."); *see also In re Terrace Gardens Park P'ship*, 96 B.R. 707 (Bankr. W.D. Tex. 1989).

[228] *See, e.g.*, *In re Nicole Energy Servs., Inc.*, 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).

[229] *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 Cnty. (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).

property free and clear of a lien where the lienholder's claim will be paid in full out of the proceeds of the sale or otherwise.

The conventional wisdom is that section 363(f)(5) also 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 interest 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.[230] A 2008 decision of the Ninth Circuit Bankruptcy Appellate Panel in *Clear Channel* reached a contrary result, finding that the possibility of cramdown did not satisfy section 363(f)(5)'s 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.[231] At the time, the *Clear Channel* decision generated considerable concern, but nearly all subsequent cases—even those in the Ninth Circuit—have reached the opposite conclusion.[232]

Buyers should weigh carefully the risk of objections to the sale from undersecured creditors where the cash purchase price likely will not satisfy all lienholders' claims. On the other hand, if the underwater liens are junior, it is probable that they will be deemed to have consented to the sale under section 363(f)(2), since, as discussed, typical intercreditor agreements include the consent of junior lienholders 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.

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[230] *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).

[231] *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).

[232] *See, e.g.*, *In re Bos. Generating*, 440 B.R. at 333 (declining to follow *Clear Channel* and holding that "the existence of judicial and nonjudicial foreclosure and enforcement actions under state law can satisfy section 363(f)(5)"); *In re Jolan, Inc.*, 403 B.R. 866, 870 (Bankr. W.D. Wash. 2009) (noting that *Clear Channel* took a particularly narrow view of section 363(f)(5) because the parties had not identified legal and equitable proceedings that would satisfy the provision's requirements, and the court chose to limit its holding to the arguments presented by the parties; going on to identify numerous "legal and equitable proceedings [under applicable state law] by which a junior lienholder could be compelled to accept money satisfactions").

Finally, section 363(f)(5) can also be used to protect a purchaser from liability for unsecured claims that arose from operation of the purchased assets before the sale. However, a section 363 sale will not always extinguish a purchaser's liability if potential holders of such claims did not or could not receive adequate notice that their claims would be eliminated by the sale. This issue most commonly arises in the context of injuries which occur post-sale but result from defects in products that were manufactured by the debtor before its bankruptcy.[233] These issues are discussed in greater detail in Part III.B.3 below.

b. *Risks and Disadvantages of Using Section 363*

(i) Public Auction Generally Required

Buying assets in a bankruptcy can be done quickly, but not 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 and/or the auction process itself. 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 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 objections and interference, it also may create greater execution risk for both buyers and sellers than exists outside of bankruptcy.

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[233] *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).

(ii) Potential for Delay

Although section 363 sales sometimes happen very quickly, the bankruptcy process has usually been known more for its delays than for its expedition. 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.[234] 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 opportunity for delay can arise in connection with approval of proposed bidding procedures. It is not uncommon for the official creditors' committee or other parties in interest to object to aspects of the bidding procedures, asking the court to reject the deal 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) it may believe (or hope) that a longer marketing process will yield additional and higher bids.

Further delay can arise from objections to the sale filed by the official creditors' committee or other parties in interest, both before and after an auction has concluded. Such objections are often designed to cause the debtors and purchaser to renegotiate terms of the purchase agreement and sweeten the recovery for creditors. 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 in bankruptcy, since the court will hold paramount the goal of maximizing value for the debtor's estate. 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.3.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 court that will hear the appeal. The same rule, however, permits the court to shorten the 14-day waiting

[234] *See* Fed. R. Bankr. P. 2002(a)(2).

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,[235] other than to challenge improprieties in the bidding process.[236] 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 and, as discussed, be essentially immune from reversal on appeal.[237]

(iii) Transfer Taxes

One reason for purchasing assets pursuant to a plan of reorganization rather than a section 363 sale is that purchases pursuant to a plan are exempt from state and local transfer taxes under section 1146(a) of the Bankruptcy Code.[238] These taxes can be substantial. For example, the sales tax payable on transfers of tangible personal property generally is 9.5% in Los Angeles[239] and 8.875% in New York City (combined state and city rates),[240] numbers large enough to make a difference to a buyer or seller in a bankruptcy sale (depending on which of them has agreed to be liable for the payment in negotiations). Sales of stock only rarely generate transfer taxes, however. 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

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[235] *See In re O'Brien Env't 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).

[236] *Kabro Assocs. of W. Islip, LLC* v. *Colony Hill Assocs. (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).

[237] *See* Part III.A.3.d.

[238] *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).

[239] Cal. Dep't Tax & Fee Admin., *California Sales and Use Tax Rates by County and City*, CDTFA-95 Rev. 21 (1-20) (Apr. 1, 2021), www.cdtfa.ca.gov/taxes-and-fees/TaxRatesbyCountyandCity.pdf.

[240] N.Y.C. Dep't Fin., *New York State Sales and Use Tax* (last visited Apr. 14, 2022), www1.nyc.gov/site/finance/taxes/business-nys-sales-tax.page (Business NYS Sales Tax).

of the ultimate parent corporation. Where such taxes are a major economic issue, consideration should be given to folding the sale into a plan of reorganization.

3. The Nuts and Bolts of a Section 363 Sale

a. *Key Steps*

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

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

- *Prepetition marketing period.* The seller and its investment banker market the assets, either privately or publicly, to likely purchasers, execute NDAs with potential bidders, distribute information memoranda, provide access to a virtual data room, and arrange site visits.

- *Stalking horse selected.* The board of directors of the seller reviews bids with its financial and legal advisors and selects the highest and best offer as a "stalking horse."

- *Definitive documentation.* The seller negotiates with the bidder and the debtor's prepetition and postpetition financing sources and enters into a definitive purchase agreement with the stalking horse bidder,[241] subject to any higher and better bids resulting from an auction process to occur after bankruptcy is filed. All of the 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.

- *Bankruptcy preparation.* The seller simultaneously prepares other necessary papers for its bankruptcy filing, including the bankruptcy petition, schedules of assets and liabilities, and so-called "first day" motions and related orders. In particular, debtor-in-possession financing must be found and negotiated. It is not uncommon for the prospective acquiror itself

[241] If the seller does not identify a stalking horse bidder prior to filing for bankruptcy, the seller will usually include a form of a purchase agreement that potential bidders can comment on in connection with their bid.

to provide debtor-in-possession financing.[242] This has the effect of magnifying the benefits of the stalking-horse position (discussed below), including enhanced access to information, control over case milestones, and the like.

- *Filing the petition and sale motion.* The seller files its chapter 11 petition, accompanied by a motion seeking approval of the bidding procedures for the postpetition auction process and the sale of the seller's assets to the ultimate winning bidder (agreed forms of court orders are filed as exhibits). Other motions are filed seeking relief with respect to matters requiring immediate authorization, such as debtor-in-possession financing.

- *Bidding procedures hearing.* Parties in interest may object to the bidding procedures, and the bankruptcy court conducts a hearing to address these objections, typically within 20 to 30 days of the filing of the sale motion, after which a bidding procedures order is entered. However, in circumstances where the debtor's business or assets are the proverbial "melting ice cube," time periods may be drastically curtailed.

- *Postpetition marketing period.* The seller and its investment banker market the assets a second time, in accordance with the bidding procedures. Prospective competing bidders will have a specified time period to conduct due diligence and submit qualified bids (as defined in the bidding procedures). If other qualified bidders emerge, an auction is 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 documented in writing later.) After each round of bidding, the seller and its advisors, together with the official creditors' committee and its advisors, will analyze the bids and conclude which bid is highest and best.

- *Sale hearing.* As soon as possible after the winning bid is selected, the debtors will seek bankruptcy court approval of the sale to the winning

[242] A unique, high-profile example is the Brooks Brothers bankruptcy, in which the hopeful acquiror offered a DIP loan at 0% interest, which it then credit bid to acquire the assets. *See* Steven Church, *Brooks Brothers Gets Bankruptcy Loan with Zero Interest Rate*, BLOOMBERG, July 10, 2020, www.bloomberg.com/news/articles/2020-07-10/brooks-brothers-gets-bankruptcy-loan-with-zero-interest-rate; Sapna Maheshwari, *Bankruptcy Brooks Brothers Finds a Buyer*, N.Y. TIMES, Aug. 12, 2020, www.nytimes.com/2020/08/12/business/brooks-brothers-sale-authentic-brands.html.

> bidder. Parties in interest may object to the sale generally, as well as to the proposed assumption and assignment of the identified contracts and leases.[243] Once all objections are resolved or overruled, the court will enter an order approving the sale.

Needless to say, this process is intended to cause a stalking horse to be outbid (or to improve its own bid, whether the price or other terms) between the time it enters into the initial agreement with the seller and the entry of a bankruptcy court order approving the sale. As a result, the eventual purchase price may greatly exceed the amount of the stalking horse bid.[244]

However, it is also possible that the mere presence of a stalking-horse bidder, particularly a well-heeled strategic buyer, may cause other potential bidders to assume that the 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 also not uncommon for the stalking horse to be the only and winning bidder.[245]

b. *It 'Ain't Over til it's Over'*

The winning bidder should insist that the debtor seek bankruptcy court confirmation of the auction results as soon as possible to avoid the possibility of another 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 violations of bidding rules

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[243] It is not uncommon for objections to individual contracts and leases to be pushed off to a separate hearing. *See* Part III.B.7.

[244] There are many examples of this. In 2014, a stalking-horse bid of $84 million for substantially all of the assets of Natrol Inc. was topped by a winning bid at auction of $133 million; in 2018, a stalking-horse bid of $200 million for substantially all assets of Nine West Holdings, Inc. was topped by a winning bid at auction of approximately $340 million. In the Nortel Networks bankruptcy in 2011, a patent portfolio was eventually sold for $4.5 billion, five times the stalking-horse bid of $900 million.

[245] *See, e.g.*, Findings of Fact, Conclusions of Law, and Order Confirming [. . .], *In re GNC Holdings, Inc.*, No. 20-11662 (Bankr. D. Del. Oct. 14, 2020), ECF No. 1415 (Harbin Pharmaceutical Group Co., Ltd. was the stalking horse and only qualifying bidder); Order Approving the Sale of Substantially All of the Debtors' Assets, *In re Approach Res., Inc.*, No. 19-36444 (Bankr. S.D. Tex. Mar. 4, 2020), ECF No. 301 (Alpine Energy Acquisitions, LLC was the stalking horse and only qualifying bid); Order Approving Sale of Substantially All of the Debtors' Assets, *In re Synergy Pharm., Inc.*, No. 18-14010 (Bankr. S.D.N.Y. Mar. 1, 2019), ECF No. 484 (Bausch Health Companies, Inc. was the stalking horse and winning bidder).

approved in a bankruptcy court order are sometimes countenanced, although some bankruptcy judges will respect prior-approved procedures.

In the *Comdisco* chapter 11 case, for example, the bankruptcy court refused to reopen the auction to consider a revised bid from Hewlett-Packard Company, the losing bidder, after the U.S. Department of Justice sued to enjoin the sale to the winning bidder, SunGard Data Systems, Inc., on antitrust grounds. The official creditors' committee asked the court to approve Hewlett-Packard's bid, even though it was lower than SunGard's winning bid, because it was not subject to antitrust risk. After a contested hearing, the court ruled that the debtor was required to continue with SunGard, in compliance with the court-approved bidding rules.[246]

Other courts, however, have reopened the 363 sale process despite the previously approved bidding procedures. For example, in the bankruptcy of Polaroid Corporation, 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.[247] 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 that included less cash but granted creditors a larger stake in the company to 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 prevailed with a greatly increased bid of $87.6 million. 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.[248]

Recognizing that reopening bidding implicates the competing concerns of maximizing creditors' recovery and ensuring finality and regularity in bankruptcy

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[246] *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).

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

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

sales, courts sometimes use a "sliding scale" approach, holding that the further along the parties have gotten in the sale process, and the more "crystallized" their expectations of finality, the less likely an "upset" bid will be allowed.[249] 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.[250] Before a sale order is entered, however, as discussed, some bankruptcy courts have exercised their discretion to accept upset bids.[251] Bankruptcy courts considering whether to accept an upset bid have taken into account the robustness and integrity of the auction process, including the formality and complexity of that auction, the difficulty in valuing competing offers and the clarity of the auction's resolution.[252] To reduce the risk of upset bids being

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

[250] *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))).

[251] *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).

[252] *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 and stating that, in a properly conducted auction with "simple and clear" bidding procedures, enforcing the "integrity of the judicial process" is a weightier factor than maximizing estate value), *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 Fairfield Sentry Ltd.*, 539 B.R. 658, 668-71 (Bankr. S.D.N.Y. 2015) (holding that "the decision whether to reopen the auction is committed to the bankruptcy court's discretion"), *aff'd*, 690 F. App'x 761 (2d. Cir. 2017), *cert. denied*, 138 S. Ct. 285 (2017).

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 case where a public auction is not undesirable, hold the auction on the record in open court.[253]

c. *Backup Bidder Status*

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 requirement in order to preserve for itself the opportunity to reconsider its options if the high bidder walks away from its deal.

d. *Bidder Standing*

Typically, unsuccessful bidders do not have standing to appeal an approved sale, and some courts have held that potential bidders lack standing even to challenge the bid procedures unless they are also creditors.[254] (A stalking-horse bidder, however, may seek to include in the bidding procedures a grant of standing for it to object to the debtors' determination of qualified bidders prior to the commencement of an auction.) As discussed in detail in Part IV.B.2, the purchase of claims in a bankrupt company is one way to obtain standing to make these challenges. 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.

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[253] *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").

[254] *Compare In re O'Brien Env't 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 Renco Grp.* v. *Buchwald (In re Magnesium Corp. of Am.)*, 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). This issue is discussed further in Part IV.B.2 below.

4. Bidding Incentives

A company selling its assets in a 363 sale will utilize bidding incentives to attract and retain a stalking horse bid and incentivize a robust auction.[255] In general, courts permit debtors to use bidding incentives as long as the parties negotiate at arm's-length and such incentives encourage, rather than chill, bidding for the assets.[256]

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. The debtor will normally include proposed bid protections in a stalking-horse purchase agreement attached to its motion to approve bid procedures. We discuss a handful of typical bidding protections below.

(i) Expense Reimbursement

At a minimum, a stalking horse will require that a seller commit to reimbursing its out-of-pocket costs related to due diligence and the sale negotiation, generally subject to a cap, if it is outbid. 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 purchase price over the stalking horse's offer, minus the cost of reimbursement.[257] An expense reimbursement provision thus is considered to be the least controversial form of bidding protection.

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[255] *See Official Comm. of Subordinated Bondholders* v. *Integrated Res., Inc. (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 or minimum for other bidders to follow, or (3) to attract additional bidders"), *appeal dismissed*, 3 F.3d 49 (2d Cir. 1993).

[256] *See id.* at 657 (considering relationship of parties and whether incentive "hamper[s]" bidding); *cf. O'Brien Env't 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), *cert. denied sub nom. NextEra Energy, Inc.* v. *Elliott Assocs., L.P.*, 139 S. Ct. 1620 (2019).

[257] *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).

(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."[258] 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 2% to 4%)[259] if the stalking horse's bid attracts better offers and the seller consummates a sale to a higher bidder. 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 the stalking horse's 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.[260]

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[258] *In re 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.

[259] Courts tend to approve as reasonable break-up fees in the range of 2% 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 break-up fees in this range, *see* Order (I) Authorizing and Approving the Sale of Substantially All of the Assets of Donlen Corporation and its Debtor Subsidiaries[…], *In re The Hertz Corp.*, No. 20-11218 (Bank. D. Del. Mar. 2, 2021), ECF No. 2915 (2.9% break-up fee, consisting of $24.75 million break-up fee less the amount of any reimbursement expenses in excess of $7.5 million, on $850 million bid); Order Approving (A) The Sale of Substantially All of the Debtors' Assets[…], *In re Approach Res., Inc.*, No. 19-36444 (Bankr. S.D. Texas Mar. 4, 2020), ECF No. 301 (2.7% break-up fee plus reimbursement of expenses up to $250,000, on $192.5 million bid); Order (A) Approving the Purchase Agreement[…], *In re Francesca's Holdings Corp.*, No. 20-13076 (Bankr. D. Del. Jan. 22, 2021), ECF 384 (3.0% break-up fee, plus reimbursement of expenses up to $350,000 on an $18 million bid). For cases approving somewhat larger fees, *see, e.g.*, Order (A) Establishing Bidding Procedures Relating to the Sale of Substantially All of the Debtors' Assets[…], *Mabvax Therapeutics Holdings, Inc.*, No. 19-10603 (Bankr. D. Del. Apr. 8, 2019), ECF No. 78 (5% break-up fee, plus reimbursement of expenses up to $100,000, on a $3.7 million bid); Order Approving Debtors' Expedited Motion to approve (I) Procedures for the Consideration of Investment Bids of a Plan Sponsor and Alternative Section 363 Asset Purchase Offers[…], *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); Order Approving (A) the Backstop Commitment Letter[…], *In re Magnachip Semiconductor Fin. Co.*, No. 09-12008 (Bankr. D. Del. Sept. 1, 2009), ECF No. 250 (10% break-up fee, albeit one that was payable in stock, not cash).

[260] *See DDJ Cap. Mgmt., LLC* v. *Fruit of the Loom, Inc. (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

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.

Break-up fees are more controversial than expense reimbursement provisions. 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.[261] Detractors note that a break-up fee can be a powerful tool for a seller aiming to "steer" a sale to a favored prospective purchaser—*e.g.*, a bidder that is likely to retain current management after completing the sale.[262] 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 the auction.[263]

(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 the stalking-horse bid by a certain amount.[264] Minimum overbids

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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).

[261] *See* Lackey, *supra*, 93 COLUM. L. REV. at 739-40.

[262] *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").

[263] 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, e.g.*, *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 debtor's ability to sell to highest bidder), *aff'd sub nom. In re 310 Assocs.*, 346 F.3d 31 (2d Cir. 2003).

[264] *See, e.g.*, *In re The Hertz Corp.*, No. 20-11218 (Bankr. D. Del. Mar. 2, 2021), ECF No. 2915 ($2.5 million minimum for overbids; $850 million stalking-horse purchase price); *Mabvax*

generally are approved if reasonable. Aside from providing some modicum of deal protection to the stalking horse, they minimize the incurrence of unnecessary transaction costs related to overbids that do not materially benefit the estate.

(iv) The Asset Purchase Agreement

In addition to price, the asset purchase agreement will contain a menagerie of material non-economic terms, including provisions regarding the scope of the assets/liabilities to be transferred/assumed, the treatment of executory contracts, any upfront deposit against the purchase price,[265] the treatment of management and other employees, closing conditions and termination rights.

Debtors will often encourage competing bidders to use the form of purchase contract negotiated between the debtor and the stalking horse. Doing so may enhance the comparability of competing offers (and therefore the efficiency of the auction process) and reduce the costs of diligencing the transaction. But it also can provide effective—and arguably unfair—protections for a stalking horse that insists 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 such provisions may be showstoppers for a strategic purchaser. While competing bidders may elect to submit non-conforming bids, they are generally strongly encouraged (if not required) to submit a markup of the stalking horse's form of agreement. The economic impact of differences between the stalking horse's form of agreement and the competing

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Therapeutics Holdings, Inc., No. 19-10603 (Bankr. D. Del. Apr. 8, 2019), ECF No. 78 ($100,000 minimum for overbids; $18 million purchase price).

[265] 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 (which was 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. *See* Order (I) Authorizing Fixed/Floating Debtors to Enter Into Second Amended Commitment Letter [. . .], *In re Innkeepers USA Trust*, No. 10-13800 (Bankr. S.D.N.Y. Oct. 21, 2011), ECF No. 2181.

bidder's proposed purchase agreement will be considered by the debtor and the official creditors' committee—and eventually by the court—when evaluating which bid is the highest and best.

b. *When to Seek Bidding Protections*

Given the bankruptcy overlay and need for court approval, the seller in a section 363 sale is unable to provide a binding commitment before the potential purchaser incurs its due diligence costs. Instead, a potential purchaser must proceed on a non-binding promise from a seller that, if the potential purchaser becomes the stalking horse, the seller will seek to include the agreed-upon bid protections in the bid procedures order submitted for bankruptcy court approval.[266]

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 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. For example, in the *Briggs & Stratton* chapter 11 case in 2020, the U.S. Trustee argued that a 3% break-up fee was excessive under the circumstances because it threatened to chill bidding.[267] Although the court questioned "the need for a termination fee when we have sixteen other bid protections for the stalking horse bidder" it also expressed reluctance to "second guess" the debtor's process.[268] The court ultimately determined that the

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[266] *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).

[267] *See* United States Trustee's Limited Objection [. . .], *In re Briggs & Stratton Corp.*, No. 20-43597 (Bankr. E.D. Mo. Aug. 13, 2020), ECF No. 409.

[268] Transcript, *In re Briggs & Stratton Corp.*, No. 20-43597 (Bankr. E.D. Mo. Aug. 18, 2020), ECF No. 561.

bidding procedures met "the test of value maximization" and "fairness" and approved the bidding procedures.[269]

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 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 or expense reimbursement. 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's 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.[270] 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.[271] 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 reimbursement to show for their trouble.[272]

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[269] *Id*.

[270] *See Refco Seeks Fast Sale of a Unit*, N.Y. TIMES, Oct. 22, 2005, www.nytimes.com/2005/10/22/business/refco-seeks-fast-sale-of-a-unit.html; James Politi & David Wighton, *Judge Thwarts JC Flowers' Refco Play*, FIN. TIMES, Oct. 24, 2004, www.ft.com/content/bc4c2828-44c7-11da-a5f0-00000e2511c8.

[271] *See* Alexandra Berzon, *Icahn Outbids Penn National Gaming for Starting Bid on Fontainebleau*, WALL ST. J., Nov. 24, 2009, www.wsj.com/articles/SB10001424052748704779704574554251142822522.

[272] 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 Enterprises, LLC*, the court held that the losing bidder had standing to apply for reimbursement on

A related risk is that the stalking-horse bidder may have to increase its offer in the face of a competing bid in order to obtain court approval of its bid protections. For example, in the 2012 bankruptcy of Residential Capital LLC, Fortress Investment Group 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.[273]

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

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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.

[273] *See* Steven Church, *Fortress to Be First Bidder at ResCap Mortgage-Unit Sale*, BLOOMBERG, July 29, 2021, www.bloomberg.com/news/articles/2012-06-19/fortress-to-be-first-bidder-at-rescap-mortgage-unit-sale.

that bid, however, it may later find it difficult to obtain desired protections and incentives in the event it is outbid.[274]

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 than deferring to the debtor's business judgment, courts in the Third Circuit typically evaluate whether a break-up fee or agreement to reimburse expenses is "actually necessary to preserve the value of the estate" under Bankruptcy Code section 503(b), the provision governing reimbursement of administrative expenses.[275] This standard stems from the decision of the Third Circuit Court of Appeals in *In re O'Brien Environmental Energy*, 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. 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." 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." 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

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[274] *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).

[275] *See In re O'Brien Env't Energy, Inc.*, 181 F.3d 527, 535 (3d Cir. 1999).

the cost of submitting a bid," the court found that reimbursement of expenses was unnecessary to preserve value for the estate.[276]

A later opinion from the Third Circuit, in *In re Reliant Energy Channelview LP*,[277] 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 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."[278] 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.[279]

Notwithstanding the seemingly more difficult standard imposed by the Third Circuit in *O'Brien* and *Reliant Energy*, bankruptcy courts in Delaware have generally found that proposed break-up fees satisfy that standard, and regularly approve break-up fees.

Even when the bankruptcy court has approved the proposed break-up fee, however, the stalking horse may not be assured of its payment. One case from the Third Circuit offers a cautionary tale. 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 had not been obtained. The bankruptcy court granted a creditor's motion to reconsider its prior order approving the breakup fee, finding that an "incomplete and confusing" record had been made at the hearing, resulting in the court's not

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[276] *O'Brien*, 181 F.3d at 532-38.

[277] *In re Reliant Energy Channelview LP*, 594 F.3d 200, 206 (3d Cir. 2010) (applying the *O'Brien* standard).

[278] *Id*. at 207.

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

having understood that the break-up fee would be payable if the deal failed due to lack of regulatory approval.[280] The bankruptcy court's decision was affirmed by the Third Circuit.[281] Unable to recover its breakup fee, NextEra next sought reimbursement as an administrative expense for $60 million in out-of-pocket expenses and other costs incurred in connection with its bid.[282] The bankruptcy court also rejected this claim, finding that NextEra did not benefit the estate because Energy Future Holdings was ultimately forced to find an alternative transaction worth far less.[283] The Third Circuit, however, found that NextEra had plausibly satisfied the *O'Brien* standard based on its argument that it "benefitted the estate by providing valuable information, and accepting certain risks, that paved the way for" the eventual purchaser.[284] The Third Circuit remanded the case for fact-finding to determine whether the benefit that NextEra provided "outweighed the costs it imposed, such that it is entitled to administrative fees."[285] While NextEra may yet recoup some of its expenses, its experience shows the risks that a stalking horse purchaser can face even when break-up fee provisions have been approved by the bankruptcy court.

5. To Be or Not to Be the Stalking Horse

In addition to the bidding incentives and protections discussed in Part III.A.4.a of this outline, there are other advantages (and a few potential drawbacks) a prospective purchaser seeking to act as the stalking-horse bidder should consider.

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 greater access to the seller's management team. This superior information flow allows the stalking horse to make its bid with greater confidence and potentially outbid competitors before they even enter the process. Competing bidders, which will likely bid with less time to

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[280] *In re Energy Future Holdings Corp.*, 575 B.R. 616, 631-33 (Bankr. D. Del. 2017), *aff'd*, 904 F.3d 298 (3d Cir. 2018), *cert. denied sub nom. NextEra Energy, Inc.* v. *Elliott Assocs., L.P.*, 139 S. Ct. 1620 (2019).

[281] 904 F.3d at 298.

[282] *See* 990 F.3d 728 (3d Cir. 2021).

[283] *See id.* at 735.

[284] *Id.* at 747. The court focused on NextEra's work on due diligence, regulatory approvals, drafting purchase documents and bankruptcy plan, and negotiating with creditors.

[285] *Id.* at 748.

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 and transaction timeline along with the debtor.

Why might a potential bidder choose not to be the stalking horse? In bankruptcy, a prospective bidder will seldom be turned away. A competing bidder has the ability to wait and see what the stalking horse will do and leverage the stalking horse's due diligence and purchase contract and the signaling of value of its 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 other party in interest will object and retrade important deal 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 intrusive discovery) without assurance that the stalking-horse agreement will be approved and the debtor will cover the related costs.

6. Credit Bidding

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 currency to purchase their collateral—a practice known as "credit bidding."[286] 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 and recoveries for the secured creditors higher. While credit bidding a large amount or all of a secured claim has advantages, discussed below, credit bidding less than face value may also have strategic value, 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.

While credit bidding provides secured creditors with important protection from their collateral being sold by the debtor on the cheap, it also can distort the economics of a competitive bidding process. It is generally accepted that, in the context of a section 363 sale, creditors may credit bid up to the full face amount of

[286] *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).

their debt regardless of the underlying collateral value.[287] As a result, a credit bidder whose claim is substantially undersecured—even if the claim was purchased at a steep discount to its face amount—can push the price well above the value of the asset, thereby effectively shutting down any realistic possibility of competing bids.[288]

Section 363(k) of the Bankruptcy Code gives the court discretion to limit the right to credit bid "for cause," although "cause" is not defined. "Cause" has been found in cases where the secured creditors' claims or liens are subject to challenge, either by the debtor or by other creditors.[289] 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 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, a buyer seeking to acquire a claim to credit bid must be mindful that its bid may be subject to litigation risk and delay.

The *Sears* bankruptcy is another example of a credit bid being subjected to significant challenge. The only bid for the Sears' assets (other than from liquidators) was a credit bid from ESL Investments, which was the holder of 49% of Sears' equity and much of its secured debt.[290] The proposed bid drew objections

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[287] *See Cohen* v. *KB Mezzanine Fund II, L.P. (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…."); *Aetna Realty Investors, Inc.* v. *Monarch Beach Venture, Ltd. (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 section 363(k) had each allowed the creditor to bid its entire claim).

[288] As discussed below, creditors have had limited success in arguing that credit bidding should be disallowed "for cause" under section 363(k) if it has the effect of "freezing bidding."

[289] *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).

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

from the creditors' committee on the basis that ESL Investments' secured claims should be subordinated, recharacterized as equity investments, or otherwise invalidated.[291] Following an extensive investigation and a multi-day hearing, the bankruptcy court approved ESL's use of its secured claims to credit bid.[292]

A few courts have taken a somewhat broader view of what constitutes grounds to disallow or limit the right to credit bid. In *In re Philadelphia Newspapers*, the Third Circuit suggested in *dicta* (*i.e.*, the opinion did not include a finding regarding cause under section 363(k)) that a court may deny a credit bid "in the interest of any policy advanced by the Code, such as to ensure the success of the reorganization or to foster a competitive bidding environment."[293] Consistent with this broader view, in *Fisker Automotive Holdings*, 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.[294] In *Free Lance-Star Publishing*, the bankruptcy court 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. The court found that the lender had engaged in aggressive behavior which, rather than preserving asset value, depressed bids.[295]

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[291] *See, e.g.*, Obj. of the Official Comm. of Unsecured Creditors to Sale of Substantially All of the Debtors' Assets to ESL Investments, Inc. ¶¶ 90, 138-73, *In re Sears Holdings Corp.*, No. 18-23538 (Bankr. S.D.N.Y. Jan. 31, 2019), ECF No. 2309.

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

[293] 599 F.3d 298, 316 n.14 (3d Cir. 2010). The central holding of *Philadelphia Newspapers* is no longer good law in light of *RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank*, 566 U.S. 639 (2012), but the Supreme Court's decision did not address the Third Circuit's comment on the breadth of "cause" under section 363(k).

[294] *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).

[295] *In re The Free Lance-Star Publ'g Co.*, 512 B.R. 798, 805 (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).

Other courts have declined to adopt this broader view of cause under section 363(k). In the chapter 11 of retailer Aéropostale in the Bankruptcy Court for the Southern District of New York, the debtors sought to disqualify a secured lender from credit bidding in a proposed 363 sale, relying largely on *Fisker* and *Free Lance-Star*.[296] Rejecting the debtors' argument that a credit bid could be rejected solely because it chilled the bidding process, the bankruptcy court allowed the secured lender to credit bid the full amount of its secured claim. The court ruled that the potential chilling effect of a credit bid, in and of itself, typically 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 on the part of the lenders whose bids were rejected.[297]

A particularly difficult issue may arise when the secured claim is held by a group of creditors who disagree over the use or terms of a credit bid. It is typical that the governing credit documents invest the authority to credit bid in the agent, which can be instructed by the holders of an agreed percentage of the debt, generally a majority. In *In re GWLS Holdings*,[298] the Bankruptcy Court for the District of Delaware 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.[299] It relied on contractual provisions that entitled the collateral agent under the secured credit facility to exercise all available rights and remedies on behalf of lenders, including the right to dispose of collateral.

A similar result was reached by the Bankruptcy Court for the Southern District of New York in *In re Metaldyne Corp.*[300] Relying on *GWLS* and the Second Circuit's decision in *Chrysler*—which held that an agent could consent to the sale of

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[296] *In re Aéropostale, Inc.*, 555 B.R. 369 (Bankr. S.D.N.Y. 2016).

[297] *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).

[298] 2009 WL 453110 (Bankr. D. Del. Feb. 23, 2009).

[299] *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).

[300] 409 B.R. 671 (Bankr. S.D.N.Y. 2009), *aff'd*, 421 B.R. 620 (S.D.N.Y. 2009).

collateral to a third party 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.[301]

While these cases addressed the agent's ability, with the backing of all but a small holdout in the lender group, to credit bid the entirety of the secured claim, a more controversial use by the agent of its power to credit bid was sustained in 2019 in the *Empire Generating* bankruptcy in the Southern District of New York. There, a group holding 45% of the secured debt objected to the credit bid proposed by the agent, an entity affiliated with the majority lenders, which held 55% of the debt. The dissenting lenders argued that the majority lenders had unfairly distorted the process in their favor by subverting the role of the agent and instructing it to favor the majority lenders' interests over those of the group, that the majority lenders were planning to impose a corporate governance structure that would disfavor minority lenders, and that this use of a credit bid subverted the minority protections built into the chapter 11 plan process.[302] The bankruptcy court overruled the objection and approved the sale, holding that the proposed sale benefited the estate and that any disputes over governance should be litigated in state court.[303] The bankruptcy court relied in part on a previous decision in *GSC*,[304] where, facing similar arguments from the minority lenders, the court held that since the credit documents gave the agent the right to credit bid at the direction of the majority lenders, the credit bid was valid as a matter of bankruptcy law, and the issues raised by the dissenting creditors were intercreditor issues that belonged in state court.[305]

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

[302] Minority Lenders' Omnibus Obj. to Debtors' Mot. for Entry of an Order Authorizing and Directing Assumption of the Restructuring Supp. Agreement and Debtors' Sale Mot., *In re Empire Generating Co.*, No. 19-23007 (Bankr. S.D.N.Y. May 28, 2019), ECF No. 61.

[303] Tr. at 76-83, *In re Empire Generating Co.*, No. 19-23007 (Bankr. S.D.N.Y. Sept. 16, 2019), ECF No. 307. The objecting lenders' appeal was never pursued because the parties reached a settlement.

[304] *In re GSC, Inc.*, 453 B.R. 132 (Bankr. S.D.N.Y. 2011).

[305] *Id*. at 173.

Empire Generating and *GSC* both arose in the context of section 363 sales, where the protections accorded to minority creditors by the two-thirds in amount voting requirement for confirmation of a plan are inapplicable. It remains to be seen whether majority lenders could likewise direct a credit bid over the objection of minority lenders, particularly if the minority lenders would have a blocking position in a sale under a chapter 11 plan (*i.e.*, more than one-third in amount or a majority in number).[306]

One previously open issue with respect to credit bidding in connection with a plan of reorganization was resolved by the Supreme Court in *RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank.*[307] In *RadLAX*, the Court held that a plan that provides for collateral to be sold free and clear of liens cannot be crammed down on the basis that the secured creditors are receiving the "indubitable equivalent" of their claims under section 1129(b)(2)(A)(iii) if the secured creditors are not offered the opportunity to credit bid, a requirement if a plan is to be crammed down under section 1129(b)(2)(A)(ii). Thus, in both a section 363 sale and a section 1129 confirmation, credit bidding must be allowed when an asset is sold free and clear of liens,[308] "unless the court for cause orders otherwise."[309] The issue that will then potentially arise is whether the disposition of the collateral under the plan is in fact a sale.

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[306] Some courts have refused to interfere with individual creditors' rights to vote for or against the plan in other contexts, even in light of a contract, such as an intercreditor agreement, to the contrary. *See BOKF, N.A.* v. *JPMorgan Chase Bank, N.A. (In re MPM Silicones, L.L.C.)*, 596 B.R. 416, 430 (S.D.N.Y. 2019) ("The growing consensus is that agreements that seek to limit or waive junior noteholders' voting rights must contain *express* language to that effect."); *In re 203 North LaSalle St. P'ship*, 246 B.R. 325, 332 (Bankr. N.D. Ill. 2000) (refusing to enforce even an explicit contractual transfer of chapter 11 voting rights). *But see In re Coastal Broadway Sys., Inc.*, 2013 WL 3285936, *5 (D.N.J. 2013) ("There is no similar special solicitude for the protection of creditors, from fellow creditors, prepetition. Creditor rights, including their attendant voting rights, can be freely traded in the ordinary course.").

[307] 566 U.S. 639 (2012).

[308] *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").

[309] The issue of whether the terms of a chapter 11 plan are in fact a "sale" as opposed to a reorganization may still be the subject of dispute in applying the *RadLAX* decision. *See In re NNN 3500 Maple 26, LLC*, 2014 WL 1407320, *8-9 (Bankr. N.D. Tex. Apr. 10, 2014) (analyzing whether chapter 11 plan structure, which contemplated transferring the debtors' membership in a tenancy in common to a new entity, constituted a "sale" requiring credit bidding and concluding it did not).

The secured lender's right to credit bid can create other complications for competing bidders with regard to the type of consideration required to make a topping bid. 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, a credit bidder holding senior secured debt can argue that its bid is a full cash bid and thus superior to other bids—even those with a higher total face value—unless those bids include sufficient cash to repay the credit bidder's debt in full. Depending on the economic environment, this may create difficulties for a competing bidder (including junior creditors), who may be able to put forth a bid with higher aggregate value combining cash and other securities but be unable to raise sufficient financing to outbid the credit bidder in cash.

7. Secured DIP Financing Debt as a Step Towards Acquiring Control

Historically, DIP financing was provided by lenders seeking straightforward economics (interest and fees), and fully expecting repayment of their DIP in full in cash at the conclusion of the bankruptcy case. However, the role of DIP financing in the bankruptcy process has expanded to become a potential strategic device in some circumstances.

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 would-be acquiror can provide secured financing on the express understanding that it will be entitled to "bid in" or "credit bid" that debt to purchase the assets of the debtor that secure its financing, as permitted by section 363(k) of the Bankruptcy Code.[310] It is common for DIP financing to contain milestones for a sale or plan process as well as informational requirements that can enhance the potential acquiror's odds of prevailing on its bid; however, aggressive and speedy

[310] In the *Brooks Brothers* case, for example, competition to buy the debtor led one group to provide zero-interest DIP financing to the debtors; that group went on to purchase the company. *See, e.g.*, *Brooks Brothers Gets Bankruptcy Loan With Zero Interest Rate*, BLOOMBERG LAW (July 10, 2020), http://news.bloomberglaw.com/bankruptcy-law/brooks-brothers-gets-bankruptcy-loan-with-zero-interest-rate.

milestones are likely to draw objections from the official creditors committee, which will argue that more time is needed to create a competitive environment.[311]

DIP financing arrangements may also provide for repayment in the form of equity in the post-bankruptcy entity. For example, in the General Growth Properties bankruptcy, Pershing Square Capital Management proposed a DIP financing pursuant to which, upon exit from bankruptcy, 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. In *Aeroméxico*, the DIP loan included a tranche which was convertible to equity in the reorganized debtor at the lender's election.[312] Such provisions can be subject to challenge, however: In *LATAM*, the bankruptcy court declined to approve DIP financing that would have given LATAM the option to repay the DIP loan by issuing equity in the reorganized company at a 20% discount to the prepetition equityholders who were acting as DIP lenders.[313] A revised DIP removing the equity subscription election, among other adjustments, was later approved.[314]

The provision of DIP financing may also enable a secured creditor to receive enhanced treatment of its prepetition claims. For example, so-called "roll-up" financing structures afford prepetition secured lenders the opportunity effectively to convert their prepetition claims into postpetition claims. Bankruptcy courts have approved such structures when the prepetition lenders agreed in connection with the roll-up to advance new money loans and the court was convinced that no superior financing options were available. Typically, roll-up loans are secured by postpetition liens on substantially all of the debtor's assets, subject only to the liens

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[311] In a notable example of lender overreach, the bankruptcy court in *In re Tenney Village Co.*, 104 B.R. 562, 567-68 (Bankr. D.N.H. 1989), rejected DIP financing that would have given the lender control over the restructuring, including a veto right over any plan and installation of a new, lender-approved CEO.

[312] *See* Final Order Granting Debtors' Motion to (I) Authorize Certain Debtors in Possession to Obtain Post-Petition Financing [. . .], Annex A § 2.12, *In re Grupo Aeroméxico, S.A.B. de C.V.*, No. 20-11563 (SCC) (Bankr. S.D.N.Y. Oct. 13, 2020), ECF No. 527-1.

[313] *See In re Latam Airlines Grp. S.A.*, 620 B.R. 722 (Bankr. S.D.N.Y. 2020).

[314] *See* Order (I) Authorizing the Debtors to (A) Obtain Postpetition Financing [. . .], *In re LATAM Airlines Grp. S.A.*, No. 20-11254 (Bankr. S.D.N.Y. Sept. 19, 2020), ECF No. 1091.

securing the new money loans, and enjoy superpriority administrative expense status, again subject only to such status afforded to the new money loans. A roll-up structure can ensure payment in cash of prepetition secured debt (including, in some cases, undersecured debt), which otherwise would not be assured.[315]

8. 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."[316] The Clayton Act also provides for a pre-notification and waiting period requirement for acquisitions over certain thresholds.[317] These amendments to the Clayton Act are collectively referred to as the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (the "HSR Act").[318] Acquisitions of voting securities and/or assets in a bankruptcy proceeding, whether as part of a section 363 sale or in a chapter 11 plan of reorganization, are not immune from the HSR process or antitrust scrutiny.[319] However, the HSR Act

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[315] The DIP financing in the 2020 bankruptcy of OneWeb Holdings LLC illustrates this structure. In *OneWeb*, the bankruptcy court approved an arrangement whereby, for each $1 of new money provided by the prepetition secured lenders, $3 of the prepetition secured debt would be rolled up into the facility. *See* Order (I) Authorizing Debtors to Obtain Postpetition Secured Financing [. . .], *In re OneWeb Glob. Ltd.*, No. 20-22437 (Bankr. S.D.N.Y. May 1, 2020), ECF No. 121. Ultimately, approximately $90 million of prepetition secured debt was rolled up. The $1.7 billion in prepetition secured debt was undoubtedly undersecured, as an auction yielded a winning bid consisting of $150 million cash and equity worth approximately $100 million, plus incremental bankruptcy and post-emergence financing. *See* Notice of (A) Successful Bidder [. . .] at Ex. A, *In re OneWeb Global Ltd.*, No. 20-22437 (Bankr. S.D.N.Y. July 3, 2020), ECF No. 367. As part of a settlement with unsecured creditors, a large prepetition and DIP lender received equity in the acquiror rather than a cash recovery.

[316] *See* 15 U.S.C. § 18.

[317] For additional details, *see* Christina C. Ma & Monica L. Smith, *FTC Lowers Merger Filing and Interlocking Directorate Thresholds*, WACHTELL, LIPTON, ROSEN & KATZ (Feb. 3, 2021), www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.27351.21.pdf.

[318] *See* 15 U.S.C. § 18a.

[319] *See, e.g.*, Press Release, FTC, *FTC Sues to Block SoStar Group, Inc.'s Proposed Acquisition of Chief Competitor RentPath Holdings, Inc.* (Nov. 30, 2020), www.ftc.gov/news-events/pressreleases/2020/11/ftc-sues-block-costar-group-incs-proposed-acquisition-chief (FTC sued to block transaction after bankruptcy court had approved the sale on June 9, 2020); Press Release, U.S. Dep't of Just., *Justice Department Requires Divestitures as Dean Foods Sells Fluid Milk Processing Plants to DFA Out of Bankruptcy* (May 1, 2020), www.justice.gov/opa/pr/justice-department-

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.

a. *HSR Process*

As noted above, acquisitions over certain thresholds are subject to the pre-notification and waiting period requirements of the HSR Act.[320] 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).[321]

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."[322] The exemption also includes secondary purchasers of a debtor's debt securities, as well as banks and other traditional lenders.[323]

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requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa (DOJ recognized the failing firm defense to permit part of the proposed acquisitions, but required divestiture of certain plants).

[320] As discussed in Part IV.C.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.

[321] 16 C.F.R. § 803.10(b).

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

[323] *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.

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.[324] However, where a creditor holds 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;[325] in at least one instance, the FTC obtained a "blank check" that would permit it to order any divestiture it later determined was needed.[326] 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

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[324] 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).

[325] *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), 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.

[326] Press Release, FTC, *FTC Order Requires Tops Markets to Sell Seven Penn Traffic Supermarkets* (Aug. 4, 2010), 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 that the FTC later determined presented competitive concerns. The eventual FTC settlement required the divestiture of seven stores.

that the consortium take certain remedial actions and make certain behavioral commitments.[327]

Courts deciding whether to grant a preliminary injunction in an agency challenge to an acquisition may also be sensitive to the exigencies of bankruptcy proceedings.[328] 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").[329] 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 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 a 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.[330]

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[327] *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), www.justice.gov/opa/pr/statement-department-justice-s-antitrust-division-its-decision-close-its-investigations.

[328] *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, *FTC Withdraws Appeal Seeking a Preliminary Injunction to Stop LabCorp's Integration With Westcliff Medical Laboratories* (Mar. 24, 2011), www.ftc.gov/opa/2011/03/labcorp.shtm.

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

[330] 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), www.justice.gov/opa/pr/justice-department-requires-us-airways-and-american-airlines-divest-facilities-seven-key.

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" defense. The antitrust agencies and courts have long acknowledged the failing firm defense—that a transaction will not reduce competition because the acquired entity is otherwise "failing."[331] 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.[332] 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.[333] 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.[334]

The 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

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[331] *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); *see also* Press Release, U.S. Dep't of Justice, *Justice Department Requires Divestiture as Dean Foods Sells Fluid Milk Processing Plants to DFA Out of Bankruptcy* (May 1, 2020), www.justice.gov/opa/pr/justice-department-requires-divestitures-dean-foods-sells-fluid-milk-processing-plants-dfa (cited bankruptcies of two largest fluid milk processors and the pandemic causing demand for milk by schools and restaurants to collapse; certain processing plants would be shut down if not purchased).

[332] *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* (Mar. 31, 2015), www.ftc.gov/news-events/blogs/competition-matters/2015/03/power-shopping-alternative-buyer?.

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

[334] 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).

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.

9. 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 to review by the Committee on Foreign Investment in the United States ("CFIUS"), an inter-agency committee headed by the Secretary of the Treasury.

In 2018, the Foreign Investment Risk Review Modernization Act ("FIRRMA") was enacted.[335] 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.

In October 2020, the Department of Treasury announced CFIUS regulations requiring mandatory filings for two types of transactions:[336] First, a control or minority investment by a foreign person into a U.S. business that develops, designs, tests, fabricates or produces export-controlled technology if the technology at issue would require a "U.S. regulatory authorization" for export (*e.g.*, license under the International Traffic in Arms Regulations, the Export Administration Regulation, authorizations from the Department of Energy, or from the Nuclear Regulatory Commission). Second, control or minority investments where a foreign government has a "substantial interest" (defined as 49% or more) in a foreign person that will, in turn, acquire a "substantial interest" (defined as 25% or more)

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

[336] Provisions Pertaining to Certain Investments in the United States by Foreign Persons, 85 Fed. Reg. 57,124-01 (Sept. 15, 2020) (to be codified at 31 C.F.R. pt. 800).

in a U.S. business associated with critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens.

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 clearance, 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 seeking CFIUS clearance. 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.

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.[337] 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. It can also be significantly more expensive for the debtor-seller than a section 363 sale.

The complexity of the chapter 11 process makes the retention of experienced counsel and other advisors 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.

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

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

significant experience with large and complex chapter 11 cases, most notably New York, Delaware and, more recently, the Southern District of Texas.[338] If any member of a corporate family is incorporated in a desired jurisdiction and files a bankruptcy case there, any other 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[339] have been enacted.

Some debtors have attempted to establish venue in a desired venue by forming a subsidiary there shortly before filing bankruptcy and later "bootstrapping" their cases to those of their newly formed subsidiaries.[340] While such practices technically satisfy the requirements of the venue statute,[341] and have been successful in several cases,[342] some bankruptcy judges may not be convinced that they should retain such cases. In *Patriot Coal*, for example, the Bankruptcy Court for the Southern District of New York transferred cases involving Missouri-based

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[338] The Eastern District of Virginia (and, specifically, the Richmond Division) has also grown increasingly popular in recent years. Indeed, in January 2021, a District Judge for the Eastern District of Virginia entered an order transferring a high-profile chapter 11 case out of the Richmond division, writing that he "believes that reassignment is warranted here due to the practice of issuing third-party releases in the Richmond Division . . . [T]the practice of regularly approving third-party releases and the related concerns about forum shopping call into question public confidence in the manner that these cases are being handled by the Bankruptcy Court in the Richmond Division." *Patterson* v. *Mahwah Bergen Retail Grp., Inc.*, 636 B.R. 641, 703 n.16 (E.D. Va. Jan. 13, 2022).

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

[340] *See, e.g.*, *In re Boy Scouts of Am. & Delaware BSA LLC*, No. 20-10343 (Bankr. D. Del.) (BSA chartered in Washington D.C. and headquartered in Texas; Delaware BSA LLC formed before filing with assets consisting of a single deposit account).

[341] 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).

[342] *See* Anthony J. Casey & Joshua C. Macey, *Bankruptcy Shopping: Domestic Venue Races and Global Forum Wars*, 37 Em. Bankr. Dev. J. 463 (2021) (discussing how "a debtor can even create or move a small affiliate for the sole purpose of accessing venue").

coal mining businesses out of New York "in the interest of justice," notwithstanding the existence of a newly formed New York subsidiary.[343]

The highly contentious case involving the *Caesars* casino group 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 shortly thereafter the company filed voluntary chapter 11 cases for the remaining debtors in Chicago, a venue it preferred because of certain favorable law in that circuit, 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 future bankruptcy cases and limit the ability of future debtors to openly negotiate with creditors prior to filing a voluntary bankruptcy petition."[344]

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. If the debtor files a plan within that period, then other parties in interest may not file a plan until 180 days have passed since the filing of the debtor's chapter 11 petition, which allows the debtor 60 days to achieve creditor acceptance of its plan.[345] A court may reduce or increase both the 120-day and the 180-day periods "for cause,"[346] 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.[347] After the expiration of these periods, any party in interest may propose a plan.

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[343] *In re Patriot Coal Corp.*, 482 B.R. 718, 738-41 (Bankr. S.D.N.Y. 2012); *see also In re Barrington Spring House, LLC*, 509 B.R. 587, 603-07 (Bankr. S.D. Ohio 2014) (finding that venue was proper because the debtor was an "affiliate" of a separate bankrupt entity in Ohio, but still transferring the case, finding that they were filed as "an exercise of forum shopping").

[344] *In re Caesars Ent. Operating Co.*, 2015 WL 495259, at *8 (Bankr. D. Del. Feb. 2, 2015).

[345] 11 U.S.C. § 1121(a)-(c).

[346] 11 U.S.C. § 1121(d).

[347] 11 U.S.C. § 1121(d)(2).

Traditionally, establishing cause to extend plan exclusivity turned on a number of factors, including 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.[348]

After the enactment of the 18-month limit on exclusivity in 2005, the dynamic in chapter 11 cases changed measurably. In part as a result of the limit on exclusivity, but also as a result of other factors, including the trend toward use of section 363 sales in lieu of plans, the increased amount of secured debt, and the prevalence of short-term oriented investors, the playing field between debtors and creditors has leveled considerably from the days when debtors enjoyed repeated extensions to the exclusive right to file a plan. While there still are cases that languish in bankruptcy court, there is an increased sense of urgency for all constituencies from the beginning of the case. The limit on exclusivity can create a negotiation dynamic that helps to frame issues, where the impending ability of creditors to file a plan will have to be taken into account by a debtor and other creditors. In the *Lehman Brothers* chapter 11 cases, bondholders and derivatives dealers filed competing chapter 11 plans reflecting opposing positions on issues such as substantive consolidation, the treatment of guaranty claims, and valuation. After extensive negotiation, a chapter 11 plan incorporating a compromise among the major parties was proposed and confirmed. In the *LightSquared* bankruptcy, four competing plans of reorganization were filed and voted upon after the debtors' exclusivity window expired.

Nonetheless, exclusive control over the plan process for up to 18 months gives a debtor substantial negotiating leverage in the initial stages of its bankruptcy case, and exclusivity thus 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. Creditors, however, are not prevented from exploring an alternative plan during the debtor's exclusive period. Although the Bankruptcy

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[348] *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).

Code prohibits "solicitation" of votes absent a court-approved disclosure statement,[349] parties in interest may negotiate a prospective plan during the debtor's exclusive period and before approval of a disclosure statement.[350] 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."[351] Similarly, even during the debtor's exclusive period, creditors and other constituencies may be able to persuade the debtor to pursue their preferred strategic alternative. During *American Airlines*' exclusive period, for example, creditors were able to persuade the company's board, which was committed to emerging as a standalone entity, to consider a merger with US Airways, after gaining the support of key constituencies, including the unions.[352]

From the standpoint of a potential acquiror, the debtor's 18-month exclusive period generally necessitates working in conjunction with the debtor to formulate an acquisition strategy. Additionally, if secured lenders have liens on all or most of the assets to be the subject of the sale, it will be important for those lenders to be brought into the process. When dealing with a debtor that is opposed to significant asset sales, a potential acquiror may be able to persuade the bankruptcy court to terminate the debtor's exclusivity by working with official committees, whose views generally carry significant weight with bankruptcy judges, as well as other

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[349] 11 U.S.C. § 1125(b).

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

[351] *Id.* at 102. *See also In re Heritage Org., L.L.C.*, 376 B.R. 783 (Bankr. N.D. Tex. 2007) (finding that the term "solicitation" should be construed very narrowly, in deference to a clear legislative policy encouraging negotiations among creditors and stakeholders in chapter 11 cases); *In re Peabody Energy Corp.*, 2017 WL 1177911 (E.D. Mo. Mar. 30, 2017) ("'[S]olicitation' under § 1125(b) is interpreted narrowly, to leave ample room for the parties to negotiate."); *In re Sandia Resorts, Inc.*, 2016 WL 6879249 (Bankr. D.N.M. Nov. 4, 2016) (holding a communication that "ask[ed] for RWI's help in voting to accept NCG's Plan, but [did] not contain a clear request for a vote to reject Sandia Resorts' Plan" did not constitute solicitation of a vote to reject Sandia Resorts' Plan). *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).

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

core creditor constituencies, to develop a superior alternative chapter 11 plan proposal.[353]

c. *Mediation*

While mediation was traditionally regarded as a way to resolve discrete disputes between a debtor and adverse parties, it has become an increasingly important tool in the plan process in large chapter 11 cases. In recent years, mediators have been appointed to engage with claimants from all levels of a debtor's capital structure in pursuit of the resolution of the entire case through a consensual plan of reorganization.

Reflecting this trend, numerous bankruptcy courts have adopted local rules and procedures designed to facilitate mediation.[354] Bankruptcy judges in certain districts have even developed a practice of regularly referring cases to mediations presided over by other sitting judges within the same district.[355]

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[353] For example, in the 2019 *Pacific Gas & Electric* bankruptcy resulting from wildfires blamed on PG&E equipment, an ad hoc group of unsecured noteholders teamed up with the official committee of tort claimants to propose an alternative plan and sought to terminate exclusivity. The support of the tort claimants committee, which represented the parties the bankruptcy court deemed to be "most deserving of consideration," combined with a looming deadline set by the California legislature by which PG&E would need to emerge from bankruptcy to participate in the state-created wildfire fund, persuaded the bankruptcy court to terminate exclusivity. Order Granting Joint Motion of the Official Committee of Tort Claimants and Ad Hoc Committee of Senior Unsecured Noteholders to Terminate the Debtors' Exclusive Periods [. . .], *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Oct. 9, 2019), ECF No. 4167. Rather than generally terminating exclusivity, which would have allowed any party in interest to submit a plan, the court terminated exclusivity *solely* to allow the alternative plan proposal to proceed alongside the debtors' own plan. *See id.* Ultimately, the debtors settled with the tort claimants committee, the noteholders, and other constituencies, and obtained confirmation of a revised plan. *See* Order Confirming Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization Dated June 19, 2020, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. June 20, 2020), ECF No. 8053.

[354] *See, e.g.*, Local Rules for the United States Bankruptcy Court for the District of Delaware No. 9019-5 (Feb. 1, 2022).

[355] *See, e.g.*, Transcript at 73:7-12, 80:15-25, *In re Chesapeake Energy Corp.*, No. 20-33233 (Bankr. S.D. Tex. Oct. 30, 2020), ECF No. 1665 (offering to refer case to mediation before another sitting bankruptcy judge in the district).

In mass tort bankruptcies, mediation has become a particularly popular tool.[356] In this context, where supermajority tort creditor support is often essential for confirming a chapter 11 plan and a broad spectrum of non-creditor parties may be involved in the case (including insurers, non-debtor affiliates of the debtor, such as the Sackler family in the *Purdue* case, and third parties who are co-defendants in tort litigation), mediation can provide a unique forum for consolidating and addressing disputes and building consensus.[357] In some large mass tort bankruptcies, multiple mediators have been appointed.[358] This may be particularly useful where the mediators have different areas of expertise and can each focus their attention accordingly.

Several recent high-profile cases illustrate this trend. In the bankruptcy of Purdue Pharma L.P., the manufacturer of OxyContin. the debtors, creditors committee and approximately a dozen other groups asserting claims relating to the debtors' production and marketing of opioid medications participated in mediation to resolve various disputes, including most importantly, the allocation of the debtors' estate as between the private and public claimant groups. According to the

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[356] *See, e.g.*, Order (I) Appointing Mediators [. . .], *In re Boy Scouts of Am. & Del. BSA LLC*, No. 20-10343 (Bankr. D. Del. June 9, 2020), ECF No. 812; Order Appointing Mediator, *In re Imerys Talc Am., Inc.*, No. 19-19289 (Bankr. D. Del. Dec. 26, 2019), ECF No. 1370; [Mediation] Order, *In re USA Gymnastics*, No. 18-09108 (Bankr. S.D. Ind. June 17, 2019), ECF No. 514.

[357] Supermajority tort creditor support is, in some circuits, required to confirm a plan that includes non-consensual third-party releases, a feature of many mass tort plans. *See, e.g.*, *In re Continental Airlines*, 203 F.3d 203, 217 n.17 (3d Cir. 2000) (courts should consider "whether affected parties overwhelmingly have agreed to accept the proposed treatment" in assessing third-party releases); *In re Dow Corning Corp.*, 280 F.3d 648, 658 (6th Cir. 2002) ("[W]hen the following seven factors are present, the bankruptcy court may enjoin a non-consenting creditor's claims against a non-debtor: . . . (4) The impacted class, or classes, has overwhelmingly voted to accept the plan."); *Monarch Life Ins. Co.* v. *Ropes & Gray*, 65 F.3d 973, 980 (1st Cir. 1995) ("[C]ourts have taken into consideration whether (1) the creditors have overwhelmingly approved the plan, with the injunction." (citing *In re Master Mortgage*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994)). By contrast, some courts have concluded that non-consensual third-party releases are *per se* impermissible, even when a plan has supermajority tort creditor support. *See, e.g.*, *In re Purdue Pharma, L.P.*, 635 B.R. 26 (S.D.N.Y. 2021), *leave to appeal granted*, No. 22-85 (2d Cir. Jan. 27, 2022); *Patterson* v. *Mahwah Bergen Retail Gr., Inc.*, 2022 WL 135398 (E.D. Va. Jan. 13, 2022).

[358] *See, e.g.*, Order (I) Appointing Mediators [. . .] ¶ 2, *In re Boy Scouts of Am. & Del. BSA LLC*, No. 20-10343 (Bankr. D. Del. June 9, 2020), ECF No. 812 (three co-mediators); Supplemental Order re Appointment of Additional Mediator, *In re USA Gymnastics*, No. 18-09108 (Bankr. S.D. Ind. Sept. 26, 2019), ECF No. 798 (appointing additional mediator focused on insurance issues); Order Appointing Mediators, *In re Purdue Pharma, L.P.*, No. 19-23649 (Bankr. S.D.N.Y. Mar. 3, 2020), ECF No. 895 (appointing two co-mediators).

mediators' final report, the mediators conducted more than 150 sessions with the parties, resulting in the successful resolution of the allocation issue, but not all disputes.[359] In the bankruptcy of the Boy Scouts of America, the mediation involves twenty-six separate parties, including the debtor, creditors, tort claimants, insurers and other third-parties with significant interests in the case.[360]

One of the largest cases in which mediation played a significant role was the 2015 bankruptcy of Energy Future Holdings, a $42 billion chapter 11 case stemming from one of the largest leveraged buyouts in history, where the court 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.[361] In another highly contentious case, the $18 billion bankruptcy of Caesars Entertainment Operating Co., the mediation sought to resolve interlender disputes and fraudulent transfer claims against the sponsors that were at the heart of the case. The parties ultimately reached a largely consensual resolution, although it was shortly after the resignation of the mediator.[362]

Mediation poses both potential benefits and risks for all parties involved. Mediation can expedite the plan process, which can save the estate and creditors enormous litigation costs. Mediation also carries the possibility of crafting unique solutions not normally available in litigation. These benefits often flow from the ability to involve multiple constituencies in mediation, to use the mediator as a sounding board for potential arguments to the court, which can have the effect of

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[359] *See* Mediators' Report, *In re Purdue Pharma L.P.*, No. 19-23649 (Bankr. S.D.N.Y. Mar. 23, 2021), ECF No. 2548. Following the conclusion of that mediation, Bankruptcy Judge Robert D. Drain appointed fellow S.D.N.Y. Bankruptcy Judge Shelley C. Chapman to conduct mediation to resolve certain of the outstanding disputes. *See* Order Appointing the Honorable Shelley C. Chapman as Mediator, *In re Purdue Pharma L.P.*, No. 19-23649 (Bankr. S.D.N.Y. May 7, 2021), ECF No. 2820.

[360] *See* Second Mediators' Report [...], *In re Boy Scouts of America and Delaware BSA, LLC*, No. 20-10343 (Bankr. D. Del. Apr. 16, 2021), ECF No. 2624.

[361] *See* Order [. . .] Establishing the Terms Governing Mediation, *In re Energy Future Holdings Corp.*, No. 14-10979 (Bankr. D. Del. 2015), ECF No. 4497.

[362] *See* Notice of Resignation of Mediator, *In re Caesars Ent. Operating Co., Inc.*, No. 15-01145 (Bankr. N.D. Ill. 2015), ECF No. 4885; *see also* Max Frumes & Sujeet Indap, THE CAESARS PALACE COUP 285 (2021).

moderating parties' positions, as well as the ability to think outside the proverbial box in crafting resolutions.

However, mediation can also have downsides. There is some loss of control of the negotiation process, particularly for the debtor, which would otherwise be leading the pace and substance of negotiations. Mediation parties can also find their ability to make progress tied to the availability, pacing, and effectiveness of the mediator and may face pressure to keep otherwise litigable issues out of court while mediation is ongoing. Parties may also attempt to use the mediation process to stall the overall progress of the chapter 11 case.

Most forums require that discussions that occur in a mediation be kept confidential, or impose a mediation privilege.[363] This privilege is intended to encourage candid negotiations and can indeed facilitate case resolution. A potential downside is that it can foreclose discovery regarding the negotiating process that might otherwise be available in a contested plan confirmation proceeding. Both mediation participants and parties in interest who are seeking discovery related to a plan negotiated in mediation would be well advised to consult litigation counsel about the scope and implications of the mediation privilege in the relevant jurisdiction.

2. Confirmation Requirements

An investor seeking to gain control of a company through a chapter 11 plan needs to be aware of the numerous specific requirements for confirmation of a chapter 11 plan of reorganization contained in the Bankruptcy Code. A central requirement is found in section 1126(c), which provides that the acceptance of a plan requires the

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[363] *See, e.g.*, Local Rules for the United States Bankruptcy Court for the District of Delaware No. 9019-5(d) (Feb. 1, 2020) ("The mediator and the participants in mediation are prohibited from divulging, outside of the mediation, any oral or written information disclosed by the parties or by witnesses in the course of the mediation. No person may rely on or introduce as evidence in any arbitral, judicial or other proceeding, evidence pertaining to any aspect of the mediation effort . . . ."). Broad mediation privilege, however, may be falling out of favor with some courts: In the *Boy Scouts of America* bankruptcy, the court ordered mediation privileged abdicated with respect to certain issues after the mediation had already taken place. *See* Transcript of Telephonic Ruling, *In re Boy Scouts of Am.*, No. 20-10343 (Bankr. D. Del. Oct. 25, 2021), ECF No. 6798. Orders authorizing or directing mediation may also carve out certain topics from the mediation privilege or otherwise specify the discovery that is permissible. *See, e.g.*, Order (I) Appointing Mediators [. . .], *In re Cyprus Mines Corp.*, No. 21-10398 (Bankr. D. Del. Nov. 30, 2021) ("The provisions of Local Rule 9019-5(d) pertaining to 'Confidentiality of Mediation Proceedings' shall govern the Mediation; provided, however, that if a Party puts at issue any good faith finding concerning the Mediation in any subsequent action concerning insurance coverage, the Party's right to seek discovery, if any, is preserved.").

votes of at least two-thirds in amount and the majority in number of claims in each accepting class (subject to the possibility of cramdown of the plan over the class' objection, discussed below in Part III.B.2.h).[364] Additional statutory requirements for plan confirmation are discussed below.

a. *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.[365] To be approved, the disclosure statement must provide "adequate information,"[366] which the Bankruptcy Code defines as information "of a kind, and in sufficient detail" that would allow a "hypothetical investor of the relevant class to make an informed judgment about the plan."[367]

Preparing and obtaining bankruptcy court approval for a disclosure statement is rarely a significant challenge when 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, it is rare for the court to 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 unconfirmable."[368] The Bankruptcy Court for the Southern

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[364] 11 U.S.C. § 1126(c).

[365] 11 U.S.C. § 1125(b).

[366] *Id.*

[367] *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.*

[368] *See, e.g.*, *In re Am. Capital Equip., LLC*, 688 F.3d 145, 154 (3d Cir. 2012) (holding that a disclosure statement may be rejected because the associated plan of reorganization is "patently

District of Texas has gone one step further, implementing a rule designed to streamline the disclosure statement process by permitting a plan proponent to seek "conditional approval" of its disclosure statement on fourteen days' notice and without a hearing.[369] Under this procedure, a conditionally approved disclosure statement can be sent out for solicitation, and "final approval" of the disclosure statement can occur at the confirmation hearing, presumably in connection with confirmation of the plan (similar to the sequencing in prepackaged plans of reorganization).

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

b. *Obtaining Confirmation*

Once a disclosure statement is approved, the plan proponent 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 and to allow them enough time to vote. Plan solicitation must be directed to the beneficial owners rather than the record holders of claims, analogous to the "street name" concept for normal corporate voting practices.[370]

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unconfirmable" if "(1) confirmation defects [cannot] be overcome by creditor voting results and (2) those defects concern matters upon which all material facts are not in dispute or have been fully developed at this disclosure statement hearing." (internal quotations omitted and alterations in original)); *In re Firstenergy Sols. Corp.*, 606 B.R. 720 (Bankr. N.D. Ohio 2019); *In re Wong*, 598 B.R. 827 (Bankr. D. Md. Mar. 14, 2019).

[369] *See* U.S. Bankruptcy Court for the Southern District of Texas Local Rule 3016-2, www.txs.uscourts.gov/sites/txs/files/Local%20Rules%2001.11.21%20FINAL.pdf ("Combined Disclosure Statement and Plan; Conditional Approval of Disclosure Statements; Combined Hearings on Final Approval of Disclosure Statements and Confirmation of Plans in Chapter 11 Cases").

[370] *See In re Young Men's Christian Ass'n of Topeka, Kansas*, 2020 WL 7483739, *5-6 (D. Kan. Dec. 14, 2020) (concluding that the "beneficial holder, not the holder of record . . . is entitled to vote to accept or reject a debtor's plan" and that the debtor "has the duty to provide the holders of beneficial interests in the Bonds with notice of Debtor's plan and their right to vote to accept or reject the plan"); *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

An investor seeking to gain control of a company through a chapter 11 plan needs to be aware of the numerous specific requirements for confirmation of a chapter 11 plan of reorganization contained in the Bankruptcy Code. 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 impaired class (subject to the possibility of cramdown of the plan over the class' objection, discussed in Part III.B.2.h below).[371] Additional statutory requirements for the plan confirmation process are also discussed below.

c. *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."[372] 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.[373] In addition, certain claims are accorded special priority by section 507(a) of the Bankruptcy Code—including employee wage claims up to $15,150, contributions to an employee benefit plan, consumer deposits up to $3,350, and tax claims—and therefore must be classified separately from general unsecured claims.[374]

Generally, each secured claim will be classified separately based upon its distinct collateral or lien priority.[375] Secured claims of identical rank that share in the same

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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).

[371] 11 U.S.C. § 1126(c).

[372] 11 U.S.C. § 1122(a).

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

[374] 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, 2022. *Adjustment of Certain Dollar Amounts in the Bankruptcy Code*, 87 FR 6625 (published Feb. 4, 2022).

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

collateral, such as all claims of members of a secured bank group, or of holders of a secured bond issue, typically will be placed in the same class.[376]

While there is no explicit requirement that all claims or interests that are "substantially similar" be placed in the same class,[377] gerrymandering is prohibited—*i.e.*, a plan proponent may not 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)).[378] However, where there is a genuine business purpose behind providing superior treatment to creditors who will continue to provide goods and services to the reorganized debtor, courts have permitted separate classification of such claims.[379] In the *Speedcast* case in the Southern District of Texas, the debtors' plan created a separate class of unsecured creditors whose continued willingness to provide specialized goods and services were critical to the debtors' operations, and provided more favorable treatment to that class. One large creditor objected that the class was gerrymandered to create an impaired accepting class so that it could be crammed down.[380] (As the case settled, the objection was never ruled on.) Separate classification can also be justified if a creditor is shown to have differing interests than others in the class it would otherwise fall into. In the long 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

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

[377] *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).

[378] *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.").

[379] *In re Briscoe Enters., Ltd., II*, 994 F.2d 1160, 1167 (5th Cir. 1993) (permitting separate classification of city's claim where continued relationship was "essential" to debtor's future operations); *In re Nuverra Env't Sols., Inc.*, 590 B.R. 75, 96-99 (D. Del. 2018) (permitting separate classification of "trade and business-related claims" and note claims given need to preserve trade relationships); *In re Richard Buick, Inc.*, 126 B.R. 840, 852 (Bankr. E.D. Pa. 1991) (approving separate classification and superior treatment of trade claims that were necessary to future of debtor's business).

[380] Conformed Preliminary Objection of Black Diamond Capital Management, L.L.C. […], *In re Speedcast Int'l Ltd.*, No. 20-32243 (Bankr. S.D. Tex. Dec. 15, 2020), ECF No. 1098, Ex. A.

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.[381] The Bankruptcy Code also expressly permits separate classification of unsecured claims falling below a court-approved threshold amount for purposes of administrative convenience.[382] Employing this "convenience class" provision, plan proponents often choose to pay off in full small claims to avoid the expense of soliciting votes from a large number of small claimholders.

d. *Impairment and Reinstatement of Claims and Interests*

As a general matter, only claims that are "impaired" may vote on the plan. 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." While 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,[383] unimpaired classes are conclusively presumed to have accepted the plan.[384] Conversely, classes receiving or retaining nothing under a plan are deemed to have rejected the plan.[385] 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 impairs any class of claims, "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."[386] Large bankruptcy cases typically involve multiple related debtors

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[381] *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).

[382] 11 U.S.C. § 1122(b).

[383] 11 U.S.C. § 1126(c) (the thresholds are determined based on the number of voters (*i.e.*, abstentions are not counted)).

[384] 11 U.S.C. § 1126(f).

[385] 11 U.S.C. § 1126(g).

[386] 11 U.S.C. § 1124(l). 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

where a joint plan is proposed for all. In that situation, 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. Few courts have decided this "per-plan" versus "per-debtor" issue, but the only Court of Appeals decision on the topic to date follows the "per plan" approach, relying primarily on the plain language of section 1129(a)(10).[387] A handful of lower courts have reached the same conclusion.[388] In *In re Tribune Co.*, however, the Delaware bankruptcy court concluded that a plan must be confirmed on a per-debtor basis.[389] The court noted that under the Bankruptcy Code's rules of construction, the singular word "plan" includes the plural "plans," and concluded that a per-debtor confirmation requirement was more consistent with the other provisions of section 1129(a).[390]

The ability of the debtor to reinstate debt is an important corollary to the concept of impairment. Under section 1124(2), a plan can provide for a class of claims to be reinstated, meaning that creditors are placed in the same position they would have been in had the bankruptcy not occurred, and will be subject to the benefits and burdens of the original contract with the debtor post-bankruptcy. A claim that is properly reinstated will be de-accelerated and treated as unimpaired for purposes of voting on the bankruptcy plan.[391] In order to reinstate a claim, a debtor must

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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).

[387] *In re Transwest Resort Props.*, 881 F.3d 724, 729-30 (9th Cir. 2018) ("Section 1129(a)(10) requires that one impaired class 'under the plan' approve 'the plan.' It makes no distinction concerning or reference to the creditors of different debtors under 'the plan,' nor does it distinguish between single-debtor and multi-debtor plans. Under its plain language, once a single impaired class accepts a plan, section 1129(a)(10) is satisfied as to the entire plan.").

[388] *See 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) (citing cases).

[389] *See In re Tribune Co.*, 464 B.R. 126, 180-83 (Bankr. D. Del. 2011).

[390] *Id*. at 182-84.

[391] 11 U.S.C. § 1124(2).

cure all defaults other than "*ipso facto*" defaults through the bankruptcy plan.[392] 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, including "change of control" provisions that may be implicated as a result of a plan's allocation of post-emergence equity of the reorganized debtor. 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 equitizing them, only to have the debtor or another stakeholder pursue a plan that reinstates those claims on their original terms, depriving the investor of the ability to vote on the plan or to be paid with equity of the reorganized debtor.

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[392] *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 cure: "(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 hold that the 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).

Historically, reinstatement has been particularly significant in periods in which interest rates were rising and refinancing was challenging. In the PG&E bankruptcy, following protracted litigation in which an ad hoc group of noteholders were able to obtain an order terminating the debtors' exclusivity and propose a competing plan,[393] the debtors entered into a plan support agreement with that group that provided for reinstatement of approximately $9.6 billion in noteholder debt.[394] Because the utility was also issuing new secured debt, the ratable sharing provision of the applicable indentures required that, on reinstatement, the noteholders' unsecured debt would become secured.[395] The debtors ultimately obtained confirmation of a plan consistent with the noteholder RSA.[396]

e. *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 in the amount claimed therein for or against a plan of reorganization.[397] 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.[398] A partially secured creditor may vote the secured and unsecured portions of its claim as if it were the

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[393] *See* Part III.B.1.b.

[394] *See* Debtors' Motion [. . .] for Entry of an Order (I) Approving and Authorizing the Debtors to Enter Into Restructuring Support Agreement With Consenting Noteholders and Shareholder Proponents [. . .], at 13-14, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Jan. 27, 2020), ECF No. 5519; *see also* Katherine Blunt & Peg Brickley, *PG&E to Exit Bankruptcy After Wildfires, Still Straddled with Debt*, WALL ST. J., June 16, 2020, www.wsj.com/articles/pg-e-to-exit-bankruptcy-after-wildfires-still-saddled-with-debt-11592332829; PG&E Co., Quarterly Report (Form 10-Q), at *27 (Oct. 29, 2020).

[395] *See* PG&E Noteholder RSA at 13-14. *See also* Peg Brickley, *Under PG&E Deal, Bondholders Gain Protection Against Future Trouble*, WALL ST. J., Jan. 24, 2020, www.wsj.com/articles/under-pg-e-deal-bondholders-gain-protection-against-future-trouble-11579907464.

[396] *See* Order Confirming Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization dated June 19, 2020, *In re PG&E Corp.*, 19-30088 (Bankr. N.D. Cal. June 20, 2020), ECF No. 8053; Press Release, PG&E, *PG&E Emerges from Chapter 11* (July 1, 2020), www.pge.com/ en/about/newsroom/newsdetails/index.page?title=20200701_pge_emerges_from_chapter_11 (referencing the "reinstatement and collateralization" of debt).

[397] 11 U.S.C. § 1126(a); *see also In re Quigley Co.*, 383 B.R. 19, 24 (Bankr. S.D.N.Y. 2008).

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

holder of two separate claims.[399] Finally, as discussed in greater detail in Part IV.C.4 of this outline, claims may be disqualified from voting upon a showing of "bad faith."

f. *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, the 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.[400] 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.[401]

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.[402]

g. *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).[403] Courts generally require that a plan offer a "reasonable

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

[400] 11 U.S.C. § 1129(a)(7)(A)(ii).

[401] 7 COLLIER ON BANKRUPTCY ¶ 1129.02[7][b][iii] (16th ed. 2010).

[402] The best interests test can be violated as to secured claims, which might do better if the collateral were liquidated than under the proposed plan. *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).

[403] 11 U.S.C. § 1129(a)(11).

assurance of success," but need not guarantee it.[404] In practice, this is usually not a difficult legal standard for a debtor to meet.[405]

In evaluating whether a plan is feasible, bankruptcy courts often 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."[406] Frequently at issue in determining feasibility is whether a debtor's business plan is overly optimistic;[407] feasibility may also be an issue in reinstatement cases because of the risk that the financial covenants—which have not been amended—could be breached.

h. *Cramdown*

Plan confirmation can be consensual—*i.e.*, by approval of the requisite holders in all classes entitled to vote on the plan—or not. Nonconsensual plan confirmation

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

[405] *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)).

[406] *In re Young Broad. Inc.*, 430 B.R. 99, 129 (Bankr. S.D.N.Y. 2010); *see also In re Emerge Energy Servs., LP*, 2019 WL 7634308 (Bankr. D. Del. Dec. 5, 2019) (citing the same six-factor test); *In re Save Our Springs (S.O.S.) Alliance, Inc.*, 632 F.3d 168, 173 (5th Cir. 2011) (noting the same six-factor test but that there "is no requirement, however, that the court consider all six factors").

[407] *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); *In re Aurora Memory Care, LLC*, 589 B.R. 631, 642 (Bankr. N.D. Ill. 2018) (dismissing a plan of reorganization predicated on "optimistic but hollow declarations" regarding essential financing).

is referred to as "cramdown"[408] because plan confirmation is crammed "down the throat of an unwilling party" (*i.e.*, a dissenting class).[409] 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 creditors or equityholders.

To effect a cramdown, 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.[410]

Impaired Consenting Class. It is a prerequisite to cramdown that at least one class of creditors whose claims are impaired has voted to accept the plan (without counting the vote of an insider).[411]

No Unfair Discrimination. Cramdown 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."[412] The "unfair discrimination" test ensures that creditors of the same priority are not forced to accept meaningfully different levels

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[408] 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.

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

[410] *See* 11 U.S.C. § 1129(b)(1).

[411] 11 U.S.C. § 1129(a)(10). Courts construe the concept of an insider somewhat liberally for purposes of this section, 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." *In re Lichtin/Wade, LLC*, 2012 WL 6589794, at *2 (Bankr. E.D.N.C. Dec. 18, 2012) (internal quotation marks omitted). But, in *In re Village at Lakeridge, LLC*, the U.S. Court of Appeals for the Ninth Circuit construed the term "insider" more narrowly, holding that the acquisition of a claim from a statutory insider (defined by section 101(31) of the Bankruptcy Code) does not make the acquiror a statutory insider. And, despite evidence of the creditor's close personal and business relationship with the insider from whom it acquired its claim, the court upheld the finding of the lower court that the creditor in question was also not a "non-statutory insider." *See In re Vill. at Lakeridge, LLC*, 634 F. App'x 619 (9th Cir. 2016) (Mem.). The Supreme Court affirmed the Ninth Circuit's decision on narrow procedural grounds, although Justices in concurring opinions cast doubt on aspects of the Ninth Circuit's reasoning. *See 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).

[412] 11 U.S.C. § 1129(b)(1).

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.[413]

Fair and Equitable. In addition, cramdown requires that the proposed plan be "fair and equitable."[414] Whereas the "unfair discrimination" test is intended to ensure that similarly situated creditors receive similar treatment, the "fair and equitable" test is intended to preserve priorities among the different types of claims and interests, including the priority of secured claims over unsecured claims.

The Bankruptcy Code provides three alternative grounds to find a plan "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

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[413] *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). There are circumstances, however, where bankruptcy courts will countenance differing treatment for creditors of the same priority. *See, e.g.*, *In re Tex. Star Refreshments, LLC*, 494 B.R. 684, 698 (Bankr. N.D. Tex. 2013) (approving payment in full of trade creditors while judgment creditor received deferred payments of uncertain value); *In re Richard Buick, Inc.*, 126 B.R. 840, 852 (Bankr. E.D. Pa. 1991) (allowing full payment of unsecured trade claims while other unsecured claims received five cents on the dollar); *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 the 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); *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).

[414] 11 U.S.C. § 1129(b)(1).

claimant's lien attaches to the proceeds; or (3) the claimant receives the "indubitable equivalent" of its secured claim.[415]

(1) Retention of Lien and Deferred Cash Payments

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.[416] Although the application of *Till* to chapter 11 cases is a continuing source of uncertainty, many courts have concluded that the appropriate interest rate is the market rate if a relevant efficient market exists, and use the formula rate applied in *Till* otherwise.[417] The U.S. Court of Appeals for the Second Circuit followed suit in 2017 in *Momentive*, holding that the market rate must be used where an efficient market exists and reversing lower court decisions that endorsed a formula approach.[418] Depending on the interest rate environment, a great deal of value may hinge on this determination.

(2) Sale of Collateral

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 lien attaches to the proceeds of the sale, (ii) the lien on the sale proceeds satisfies one of the statutory alternatives for cramdown of a secured claim, *i.e.*, through deferred cash payments

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

[416] 541 U.S. 465 (2004) (plurality opinion).

[417] *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").

[418] *Momentive Performance Materials Inc.* v. *BOKF, N.A. (In re MPM Silicones, LLC)*, 874 F.3d 787, 799-801 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 2653 (2018).

(on the terms discussed above) or realization of the "indubitable equivalent" (discussed below), and (iii) the creditor is allowed to credit bid during the sale.[419]

(3) Indubitable Equivalent.

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 is to transfer the collateral to the creditor. Alternatively, a plan may provide for substitute collateral, typically exceeding the amount of the claim.[420] Where the substitute collateral has a different risk profile, however, a court may reject the plan for lack of indubitable equivalence.[421] Importantly, equity

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[419] 11 U.S.C. § 1129(b)(2)(A)(ii). As discussed further in Part III.A.6 of this outline, the Supreme Court held in *RadLAX* in 2012 that a debtor cannot cramdown 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. *See RadLAX Gateway Hotel, LLC* v. *Amalgamated Bank*, 566 U.S. 639 (2012).

[420] 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).

[421] In its 2012 decision in *In re River East 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 long as it doesn't increase the risk of his becoming undersecured 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.*

in the reorganized debtor has been conclusively held to be too speculative to constitute the "indubitable equivalent" of a secured claim.[422]

If the dissenting class is a class of *unsecured* claims or equity interests, section 1129(b)'s minimum requirements for a "fair and equitable" cramdown are 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."[423]

Beyond these express statutory requirements, however, courts have also described various other requirements for a plan to be "fair and equitable" as to a dissenting class. Perhaps the most important of these requirements is that a more senior class cannot receive more than payment in full over the objection of a junior class of claims or interests.[424] Therefore, in cases where the elimination of equity interests or junior classes of creditors is proposed, "an evidentiary showing that there is insufficient reorganization value for the eliminated class after payment to the senior classes" is required in order to demonstrate compliance with the fair and equitable standard.[425] In circumstances where senior creditors have provided DIP or exit financing and receive fees for doing so—often a combination of cash, additional claims under exit financing instruments and/or equity in the reorganized debtor—a dissenting junior class may argue that such fees should be factored into the analysis of whether the senior creditors are being paid more than in full, while the financing providers will argue that such fees are paid on account of the new financing and therefore should not be factored in.

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[422] *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).

[423] 11 U.S.C. § 1129(b)(2)(B)-(C).

[424] *In re SunEdison, Inc.*, 575 B.R. 220, 227 (Bankr. S.D.N.Y. 2017) ("An unwritten corollary to the absolute priority rule is that a senior class cannot receive more than full compensation for its claims."); *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."); *see* 7 COLLIER ON BANKRUPTCY ¶ 1129.03[4][a][ii].

[425] 7 COLLIER ON BANKRUPTCY ¶ 1129.03[4][a][ii].

i. *The New Value Exception to the Absolute Priority Rule*

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. The continued viability of the new value exception has been an open issue since enactment of the Bankruptcy Code. Cases that have recognized the new value exception have held that it 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."[426]

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*.[427] 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."[428] The 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

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[426] *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").

[427] 526 U.S. 434 (1999).

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

vote,[429] an examiner's report valued the consideration received by equityholders,[430] a lockup agreement between the debtor and equityholders obligated the debtor to solicit alternative offers,[431] or the debtor's exclusive right to propose a plan of reorganization was terminated.[432] 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.[433] On remand, the bankruptcy court rejected numerous plans that retained the equityholders' stake without a competitive process, and ultimately dismissed the bankruptcy case.[434] 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.

j. *"Gifting"—Another Exception to Absolute Priority?*

A decision of the Court of Appeals for the First Circuit, *In re SPM Manufacturing Corp.*,[435] has long been invoked to justify recoveries to junior creditors when a class senior to them is not paid in full as constituting a "gift" from the more senior class rather than a distribution from the debtor in violation of the absolute priority rule.[436]

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

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

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

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

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

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

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

[436] So-called "gifting 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

In the Second Circuit, *SPM* was, at a minimum, significantly limited by the 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.[437] The debtor defended the 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 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.[438] 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.[439] The *DBSD* court left open the possibility that "gifts" made outside of a plan may still be permissible.[440]

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.[441] The Supreme Court's 2017 decision in *Jevic*,[442] however,

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for the unsecured creditors was never property of the estate and its distribution therefore did not implicate the absolute priority rule.

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

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

[439] *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).

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

[441] A structured dismissal is a "hybrid dismissal and confirmation order . . . that . . . typically dismisses the case while, among other things, approving certain distributions to creditors, granting third-party releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case." *See Czyzewski* v. *Jevic Holding Corp.* (*In re Jevic*), 137 S. Ct. 973, 979 (2017) (quoting Am. Bank. Inst. Comm'n to Study the Reform of Chapter 11, 2012-2014 Final Report and Recommendations 270 (2014)).

[442] 137 S. Ct. 973 (2017).

has drawn both of these practices into question as well. 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."[443] In so holding, the Court reversed a 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 "specific and credible" grounds existed to justify deviation from the statutory priority rule;[444] according to the Court, "Congress did not authorize a 'rare case' exception" and courts therefore had no warrant for implementing any such exception.[445]

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.[446]

In addition, although the Supreme Court in *Jevic* did not discuss gifting to junior creditors under a plan, 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.[447] Even after *Jevic*, however, at least one lower court has approved a gifting plan and was not reversed on appeal to the Third Circuit.[448]

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[443] *Id*. at 976-77.

[444] *In re Jevic*, 787 F.3d 173, 180, 184 (3d Cir. 2015), *as amended* (Aug. 18, 2015), *rev'd sub nom. Czyzewski* v. *Jevic Holding Corp.*, 137 S. Ct. 973 (2017).

[445] 137 S. Ct. at 987.

[446] *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*).

[447] 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.

[448] 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% to 6% recovery and trade creditors a 100% recovery.

3. Advantages of a Chapter 11 Plan—Ability to Purchase Assets 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, 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. 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(f) is "free and clear of any *interest* in such property."[449] 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*."[450] 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.[451]

In practice, however, sale orders contain broad language precluding liability and courts often apply caselaw regarding the scope of claims able to be discharged

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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, 91 (D. Del. 2018); *see also In re Nuverra Env't Sols., Inc.*, 2017 WL 3326453 (D. Del. Aug. 3, 2017) (denying stay of confirmation order and discussing objectors' likelihood of success on the merits). The Third Circuit dismissed the appeal on equitable mootness grounds, although one judge's concurrence suggested that she would have allowed horizontal gifting. *See In re Nuverra Env't Sols.*, 834 F. App'x 729 (3d Cir. 2021) (amended Feb. 2, 2021), *cert. denied*, 142 S. Ct. 337 (2021).

[449] 11 U.S.C. § 363(f) (emphasis added).

[450] 11 U.S.C. § 1141(c) (emphasis added).

[451] *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. . . .").

under section 1141 when analyzing whether assets were sold free and clear of particular interests under a section 363 order.[452] Thus, depending on the likelihood of potential liabilities associated with a purchased asset, a potential buyer may value the speed of a sale under section 363 over the theoretically greater certainty of a discharge of liabilities in connection with a sale under section 1141.

In addition, there always 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. In addition, certain types of governmental and quasi-governmental claims may carry risks of being deemed non-dischargeable under a plan of reorganization.

Notwithstanding these issues and potential limitations, purchasers of assets through bankruptcy almost always receive significantly greater protections than purchasers of the same assets outside of bankruptcy. To state the obvious, an out-of-court purchaser will not have a federal court order that on its face bars the liabilities at issue and that, while not completely bulletproof, will effectively preclude many liabilities based on prepetition use of the assets.

However, as discussed below, these protections are subject to procedural requirements and certain limitations and risks that require careful planning and consideration, including the adequacy of notice provided to claimholders, the treatment of future claimants and mass tort claimants, and the inability to discharge certain types of claims.

a. *Adequacy of Notice*

Both the Bankruptcy Rules and constitutional due process require notice to a claimant to discharge a claim.[453] But the type of notice required depends on both

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[452] *See, e.g.*, *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).

[453] *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*

the relationship of the claimant to the debtor and whether the claim has arisen by the petition date or will only arise in the future.

In general, where the claimant is known to the debtor, actual notice will be provided by the debtor's serving the claimant with a notice of its bankruptcy petition, the bar date order, and the confirmation hearing. Notice becomes problematic with claimants who cannot be located as well as with claims that may arise in the future or that the claimant is not aware of at the time of the bankruptcy (discussed further in Part III.B.3 below).[454]

For such claimants, courts have held that notice published in newspapers or distributed using other forms of media may be sufficient as to claimants "whose interests or whereabouts could not with due diligence be ascertained."[455] For this reason, debtors who are aware of potential liabilities but not the identities of the particular claimants commonly use extensive notice-by-publication programs designed to satisfy due process requirements with respect to claimants who otherwise may, after the bankruptcy, seek to challenge any limits on their ability to pursue claims against the debtor, purchasers of the debtor's assets or others.[456]

An interesting illustration of these principles arose in the General Motors ("GM") bankruptcy, where persons who claimed to have been injured by an ignition switch

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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).

[454] *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).

[455] *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. 2009), *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 of retiree benefits following confirmation of chapter 11 plan).

[456] *See, e.g.*, *Sweeney* v. *Alcon Labs.*, 856 F. App'x 371, 373 (3d Cir. 2021) ("Kodak first published notice of the deadline for filing proofs of claim in the National Edition of *The New York Times* and in the *Democrat* and *Chronicle* in Kodak's home base of Rochester, New York. It later published notice of the confirmation hearing in *USA Today*; *The Wall Street Journal*, National Edition; and the *Democrat* and *Chronicle*."), *cert. denied sub nom. Sweeney* v. *Eastman Kodak Co.*, 142 S. Ct. 565 (2021); *In re Energy Future Holdings, Corp.*, 949 F.3d 806, 814 (3d Cir. 2020) ("EFH agreed to formulate, fund, and implement a notice plan that cost over $2 million and that led nearly 10,000 latent claimants to file proofs of claim before that date.").

defect in GM cars were not provided with notice of the bankruptcy. When those plaintiffs later asserted claims against GM, the bankruptcy court found that GM had not provided all of the plaintiffs with adequate notice. It held that those claimants who were capable of being identified by the debtor—*i.e.*, those who were direct purchasers of cars from GM—were entitled to actual notice and not merely publication notice. On the other hand, the identity of secondary purchasers of GM cars were not known to GM, thus they could be bound on the basis of the widespread notice by publication and their claims were discharged.[457] Ultimately, the bankruptcy court denied the direct purchasers relief, finding that while they had not received adequate notice, they were not prejudiced because their lack of participation did not influence the outcome of the bankruptcy.[458] On appeal, the Second Circuit reversed this determination. It agreed that procedural due process required GM to provide actual notice to the known plaintiffs, but disagreed with the bankruptcy court's conclusion that the known plaintiffs were not prejudiced by GM's failure to do so, and reversed on that basis.[459]

Even where debtors have engaged in extensive publication notice efforts, claimants may appear after the sale or plan confirmation and seek to hold purchasers of assets liable for the debtor's prepetition acts, arguing that they were unable to participate in the bankruptcy case in violation of due process. In most cases, whether those claims will be successful will depend on the nature of the claims and the scope of the debtor's noticing efforts. Potential purchasers of assets are well-advised, therefore, to diligence both the assets and the debtor's notice program.

b. *Future Claims and Mass Tort Cases*

"Future claims" are claims that have not yet arisen as of the bankruptcy filing and are often held by claimants whose identities are not known by the debtor. For example, if a debtor produced products containing asbestos, a claimant may have been exposed to the products in the past but not yet developed an illness by the date on which the debtor files for bankruptcy. In this circumstance, this person is a potential future claimant—a holder of a claim arising from the debtor's prepetition conduct but which does not manifest until after the petition date.

As this example suggests, the future claims issue arises most frequently in the mass tort context, where companies that manufactured a defective product that may still

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[457] *In re Motors Liquidation Co.*, 529 B.R. 510, 555-60 (Bankr. S.D.N.Y. 2015).

[458] *Id*. at 573-74.

[459] *In re Motors Liquidation Co.*, 829 F.3d 135, 163-66 (2d Cir. 2016).

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. For asbestos claims specifically, an elaborate set of specialized rules has been codified in section 524(g) of the Bankruptcy Code. But many cases have allowed for the resolution of potential liability from a host of mass tort claims unrelated to asbestos.

Courts have attempted to address the need to provide due process to unknown claimants by appointing a legal representative for the holders of future claims and establishing a fund for the treatment of such claims under a plan of reorganization.[460]

In such cases, the "future claimants representative" or "FCR" is tasked with representing the interests of future claimants during the bankruptcy, including ensuring that adequate funds are set aside and appropriate procedures are put in place to ensure that claims that arise after the plan is confirmed are paid.[461]

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[460] *See, e.g.*, Modified Joint Prepackaged Plan [. . .], *In re Maremont Corp.*, No. 19-10118 (Bankr. D. Del. May 14, 2019), ECF No. 241-1 (use of FCR and section 524(g) trust for claims arising from asbestos-containing auto parts); *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").

[461] Because of the FCR's role as a fiduciary for future claimants who are, almost by definition, unable to participate in the bankruptcy proceedings themselves, courts have likened the role to that of a "guardian ad litem," as "the overarching purpose of the role is to protect the rights of persons in litigation who cannot protect themselves." *In re Fairbanks Co.*, 601 B.R. 831, 840 (Bankr. N.D. Ga. 2019). As a result, when considering candidates for FCR—usually proposed by the debtor—bankruptcy courts have also begun to apply the legal standard applicable to appointment of a guardian ad litem, as opposed to the "disinterestedness" standard used when evaluating retention proposed professionals for the debtor or other fiduciaries in bankruptcy. *See* Bench Ruling on Motion to Appoint [. . .] Legal Representative for Future Talc Personal Injury Claimants, *In re Imerys Talc Am., Inc.*, No. 19-10289 (Bankr. D. Del. May 8, 2019), ECF No. 503 ("I conclude that the legal representative is much more like a guardian ad litem than those persons in the Code subject to the disinterestedness standard."); *Fairbanks*, 601 B.R. at 841 ("[T]he standard for appointing a future claimants' representative requires that the individual not only be disinterested and qualified; the future claimants' representative must also be capable of acting as an objective, independent, and effective advocate for the best interests of the future claimants. The Court must be satisfied that, like a guardian ad litem, an FCR will provide representation that is diligent, competent, and loyal."). Although candidates for FCR have typically been proposed by the debtor, there are exceptions. For example, in the *LTL Management* bankruptcy, the court approved a different method for selecting the future talc claims representative ("FTCR"), in which the debtor, official committees, U.S. Trustee, and the court itself could each propose nominees, with the FTCR ultimately being selected

Appointment of a future claimants representative is statutorily required where the debtor is seeking to utilize section 524(g), which expressly authorizes creation of a trust fund and releases in favor of certain non-debtors in asbestos-related cases.[462] Outside of the asbestos context, while appointment of an FCR is not necessarily required,[463] it is generally seen as an additional safeguard that can enhance the finality of a mass tort bankruptcy case,[464] and as a result has become a popular practice (including, for example, in the ongoing bankruptcy of the *Boy Scouts of America*).[465]

Resolution of the amount necessary to fund a trust that will be used to compensate present and future claimants through negotiation with representatives of those plaintiffs is always the goal in mass tort bankruptcies. Where settlement[466] talks fail, the court will generally use a Bankruptcy Code provision that allows for the

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by the court after discovery, limited opportunities for the parties to 'strike' candidates, and oral argument. *See* Case Management Order Setting Selection Protocol for Future Talc Claims Representative, *In re LTL Mgmt.*, No. 21-30589 (Bankr. D.N.J., Jan. 3, 2022), ECF No. 1048.

[462] *See* 11 U.S.C. § 524(g)(4)(B)(i). 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).

[463] *But cf. Sweeney* v. *Alcon Labs.*, 856 F. App'x 371, 375 n.7 (3d Cir. 2021) (observing in a footnote that, where debtor was discharging liabilities for prepetition toxic tort claims, "[s]uch circumstances might also warrant the creation of a trust and/or the appointment of a future claims representative").

[464] *See Marsh USA, Inc.* v. *The Bogdan Law Firm (In re Johns-Manville Corp.)*, 802 F. App'x 20, 24 (2d Cir. 2020) (finding that FCR's advocacy on an issue during the chapter 11 case "provided [the future claimant] with adequate representation" even though the future claimant did not individually participate in the bankruptcy). While we are not aware of any judicial opinion concluding that, where a FCR was appointed, future claimants could still not be bound by a confirmation order, the Third Circuit has suggested in dicta that such circumstances may exist. *See Sweeney* v. *Alcon Labs.*, 856 F. App'x at 374 n.5 (suggesting that it may be impossible to bind claimants who are not aware of their claims at the time of the bankruptcy).

[465] *See, e.g.*, Order Appointing [. . .] Legal Representative for Future Claimants [. . .], *In re Boy Scouts of Am. & Del. BSA LLC*, No. 20-10343 (Bankr. D. Del. Apr. 24, 2020), ECF No. 486.

[466] *See, e.g.*, Ninth Amended Joint Chapter 11 Plan of Reorganization [. . .], *Imerys Talc Am., Inc.*, No. 19-10289 (Bankr. D. Del. Jan. 28, 2021), ECF No. 2864 (containing settlement between debtors, official committee of tort claimants, future claimants representative, and various non-debtor contributors to section 524(g) trust).

estimation of "contingent or unliquidated claims, . . . the fixing or liquidation of which would unduly delay the administration of the case."[467] The plan of reorganization will then provide the amount ordered by the bankruptcy court to be funded into a trust, for tort claims to be "channeled" to the trust as they arise, and for a "channeling injunction" to restrain the assertion of tort claims against the reorganized debtor or its successor.[468]

However, where there is not yet any relationship between the debtor and the claimant who may suffer injury from the debtor's conduct or product in the future, it may not be possible to address those future claims. This is best illustrated by *In re Piper Aircraft Corp.*, which involved an aircraft manufacturer that had been named in lawsuits alleging that its products were defective and caused airplane crashes.[469] When the company filed for bankruptcy, the bankruptcy court appointed a representative for future tort claimants, and the representative 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 before confirmation of a plan, were not yet ripe and so could not be dealt with in the chapter 11 plan.[470] Similarly, other courts have refused to enforce provisions in section 363 orders[471] or chapter 11 plans that would leave future claimants who could not have known of their claim at the time of the bankruptcy without a source of recovery.

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[467] *See* 11 U.S.C. § 502(c).

[468] *See, e.g.*, *A.H. Robins*, 88 B.R. at 751; *Kane* v. *Johns-Manville Corp.*, 843 F.2d 636 (2d Cir. 1988).

[469] 58 F.3d 1573 (11th Cir. 2011) .

[470] *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).

[471] *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, 708 (S.D.N.Y. 2012) (since at the time of the section 363 sale "there was no way for anyone to know that the [plaintiffs] ever would have a claim," it would deprive the plaintiffs 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").

An acquiror of a company (or assets) with significant mass tort or other long-tailed liabilities—such as environmental or product-related liabilities—must analyze carefully the distinctive problems that 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 or no trust is in place to satisfy future claims, as it increases the practical likelihood that that buyer will be targeted by claimants after the bankruptcy.

Moreover, mass tort situations are invariably complicated. Even successful cases tend to be expensive and protracted. Pacific Gas & Electric Corporation emerged from bankruptcy in the summer of 2020 with a trust in place to pay claims arising out of the wildfires alleged to have been caused by its equipment.[472] That result followed protracted negotiations among wildfire claimants, governmental entities, holders of insurance subrogation claims, and financial creditors and shareholders. The bankruptcy process took 17 months and the debtors incurred approximately $700 million in professional fees.[473] So while bankruptcy can be a powerful tool for purchasing assets tainted by mass tort liabilities, prospective acquirors should be prepared for protracted proceedings.

c. *Non-Dischargeable Claims*

One potential risk of an acquisition through a plan of reorganization is the possibility that some claims against the debtor may be deemed non-dischargeable. In a number of recent mass tort matters, governmental entities such as states and municipalities have brought substantial tort claims against the debtor. Section 1141(d)(6)(A), added to the Bankruptcy Code in 2005, provides that confirmation of a plan does not discharge a corporate debtor for debts owed to a domestic governmental unit for debts incurred by "false pretenses, a false representation, or actual fraud" or for claims owed as a result of claims under the False Claims Act or state law equivalents.[474] This exception can present a significant risk to an acquisition under a plan of reorganization where substantial claims potentially subject to this exception may exist. The risk may be mitigated if

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[472] Notice of Entry of Confirmation Order & Occurrence of Effective Date [. . .], *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Aug. 28, 2020), ECF No. 8252.

[473] *See* Fee Examiner's Second Report [. . .] ¶ 4, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. July 2, 2020), ECF No. 8900.

[474] 11 U.S.C. §§ 1141(d)(6)(A), 523(a).

assets are instead acquired pursuant to section 363, which does not have a comparable restriction.

4. Another Advantage of a Plan—Potential Ability to Restructure Indebtedness of Special Purpose Entities

It is not uncommon for companies to use special purpose entities (SPEs), subsidiaries created solely for the purpose of incurring debt secured only by those subsidiaries' assets, to obtain financing on more favorable terms.[475] SPEs are generally intended to be "bankruptcy remote," and are subject to 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. 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.[476]

While SPEs continue to be a useful financing structure, the certainty that they would not be drawn into a bankruptcy case of a parent (or substantively consolidated with its parent in such a proceeding) was reduced somewhat by the 2009 decision in *In re General Growth Properties, Inc.*[477] *GGP* suggests that a parent-debtor may be able to file its SPE subsidiaries for bankruptcy, notwithstanding any "bankruptcy remoteness" covenants, and thereby facilitate restructuring of SPE debt. Although the bankruptcy court refused the lenders' request to dismiss the petitions of the SPE subsidiaries as having been filed in bad faith, the court expressly disclaimed any implication that GGP's SPE subsidiaries would 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.[478] Nevertheless, the lenders to the SPE subsidiaries, which

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[475] 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).

[476] *See id.*

[477] *In re Gen. Growth Props., Inc.*, 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

[478] *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).

had previously been unwilling to restructure the SPE subsidiaries' debt, agreed to such a restructuring shortly thereafter.[479] While there appears to be no similar case since the 2009 decision in GGP, the possibility that SPEs can file bankruptcy may provide sufficient leverage to cause lenders to agree to restructuring the debt of SPE subsidiaries.

5. Another Advantage of a Chapter 11 Plan—Exemption from Registration for Securities

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.[480] 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 creditor acceptance of reorganization plans by allowing certain creditors to accept a reorganization with a view to reselling securities obtained under the plan."[481]

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:

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[479] *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 (Bankr. S.D.N.Y. Dec. 15, 2009), ECF No. 3915 (confirming plan restructuring SPE subsidiaries' debt).

[480] *See, e.g.*, *In re Pac. Shores Dev., Inc.*, 2011 WL 778205, at *5 (S.D. Cal. Feb. 25, 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).

[481] *Kenilworth Sys.*, 55 B.R. at 62.

> (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.[482]

Caselaw 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

The law is unsettled as to whether the underwriter exception in section 1145(b) deprives purchasers of distressed debt claims of the protection of section 1145(a)'s securities registration exemption. Thus, investors who regularly acquire distressed debt for purposes of obtaining control of the debtor through the issuance of securities under a plan 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.

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.[483] 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, and "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."[484]

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[482] 11 U.S.C. § 1145(b)(1) (emphasis added).

[483] *See* COLLIER BANKRUPTCY PRACTICE GUIDE § 94.09 (2009).

[484] COLLIER BANKRUPTCY PRACTICE GUIDE § 94.09 (2014).

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,"[485] 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. Despite such uncertainty, debtors regularly rely on the section 1145 exemption.

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 investors and 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.[486]

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

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[485] Kurt A. Mayr, *Enforcing Prepackaged Restructurings of Foreign Debtors Under the U.S. Bankruptcy Code*, 14 AM. BANKR. INST. L. REV. 469, 501 (2006).

[486] *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 (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).

to verify that the putative seller meets the requirements for Rule 144 and that proper procedures are being followed with respect to any sale of 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. The SEC has also 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.[487]

(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.[488] 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

Rights offerings, discussed in Part III.C, involve the issuance of securities in order to raise exit capital.[489] Section 1145(a)(1)(B) of the Bankruptcy Code provides that the issuance of rights and the ultimate issuance of securities underlying those rights are exempt from registration under section 1145 if the new securities will be exchanged "principally" for claims in bankruptcy. Rights offerings—particularly

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[487] *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).

[488] 11 U.S.C. § 1145(a)(1).

[489] 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).

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 plan as requiring registration where the claims that were being traded were considered worthless.[490] Investors—particularly backstop parties—designing or participating in rights offerings should consult with experienced securities lawyers to evaluate whether the section 1145 exemption is likely to be available for the particular rights and securities being issued.

6. Another Chapter 11 Plan Benefit—Expedited Antitrust Review Standards

As discussed in Part III.A.6 of this outline, antitrust scrutiny of transactions effectuated through a chapter 11 plan of reorganization are granted expedited time frames in the United States (but not necessarily other jurisdictions) and other special considerations that may improve the prospects for the transaction's approval.

7. Another Chapter 11 Plan 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."[491] 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

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[490] *See* Practising Law Institute, *Bankruptcy Developments*, 882 PLI/CORP 47, 53-54 (1995) (discussing SEC's objection in *Penn Pacific*).

[491] 11 U.S.C. § 365(a).

material breach excusing the performance of the other."[492] In other words, an 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.[493] 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.[494] In addition, claims asserted by landlords upon rejection of long-term leases are subject to a significant cap: Rejection damages are limited

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[492] 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.

[493] *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) (fact that lessor has no interest in the premises at expiration of lease term indicated "lease" was disguised financing).

[494] *See* 11 U.S.C. § 365(g).

to the greater of one-year's rent or 15% of the remaining term of the lease in question, not to exceed three years.[495]

The Bankruptcy Code also gives a debtor a valuable right to assign (after assuming) executory contracts and leases to third parties.[496] 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 overrides contractual anti-assignment provisions, thereby maximizing the debtor's ability to extract value from its portfolio of contracts and leases.[497]

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.[498] 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 under the contract in the future.[499] The debtor must also establish that the decision to assume the contract is an appropriate exercise of its reasonable business judgment.[500]

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."[501] Thus, for example, a debtor desiring

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[495] 11 U.S.C. § 502(b)(6).

[496] 11 U.S.C. § 365(f)(2).

[497] 11 U.S.C. §§ 365(f)(1), (3).

[498] 11 U.S.C. § 365(b)(1).

[499] 11 U.S.C. § 365(f)(2); *see In re Bronx-Westchester Mack Corp.*, 20 B.R. 139 (Bankr. S.D.N.Y. 1982).

[500] *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' . . . .").

[501] 11 U.S.C. § 365(b)(1)(A); *see* 3 COLLIER ON BANKRUPTCY ¶ 365.06[3][c] (16th ed. 2010).

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 make the limited showing that such rejection falls within its reasonable business judgment, without the need to demonstrate the ability to cure or perform.[502]

b. *Collective Bargaining Agreements*

Collective bargaining agreements are a form of executory contract 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.[503] 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.[504]

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 in this necessity assessment, considering whether the modification is necessary for the debtor to avoid liquidation, not merely needed for its long-term financial health.[505] On the other hand, the Second Circuit applies a

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[502] *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").

[503] 11 U.S.C. § 1113(b).

[504] 11 U.S.C. § 1113(c).

[505] *See 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 Ent. Resorts, Inc.*, 810 F.3d 161, 172-75 (3d Cir. 2016) (affirming order

more flexible approach, looking to what the debtor needs to attain ultimate financial health.[506] Even this looser standard is demanding, however, and New York bankruptcy judges have closely scrutinized motions to reject collective bargaining agreements.[507]

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.[508] Courts have even allowed assumption or rejection decisions to be deferred until a reasonable time period after confirmation.[509]

However, the Bankruptcy Code imposes stricter timing constraints for assuming or rejecting unexpired leases of commercial real estate. A debtor is required to assume unexpired commercial real estate leases within 120 days of the petition date.[510] If a debtor fails to assume a lease within this period, the lease is deemed rejected. A

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permitting debtor to reject collective bargaining agreement where deemed necessary to avoid liquidation).

[506] *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 court must consider whether rejection would increase the likelihood of successful reorganization").

[507] *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 at 129, *In re Hostess Brands, Inc.*, No. 12-22052 (Bankr. S.D.N.Y. May 14, 2012), ECF No. 1416 (debtor did not show that 1% 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* Press Release, Teamsters, *Hostess Teamsters Vote to Accept Company's Final Offer* (Sept. 14, 2012), http://teamster.org/news/2013/08/hostess-teamsters-vote-accept-companys-final-offer.

[508] 11 U.S.C. § 365(d)(2).

[509] *See In re Greater Southeast Cmty. Hosp. Corp. I*, 327 B.R. 26, 43 (Bankr. D.D.C. 2005) ("The Bankruptcy Code permits questions of assumption or rejection under a plan to be determined after confirmation of a plan calling for such post-confirmation determination."); *see also In re UAL Corp.*, 635 F.3d 312, 321 (7th Cir. 2011).

[510] 11 U.S.C. § 365(d)(4)(A)(i).

debtor may request that the bankruptcy court extend the 120-day period only once, by an additional 90 days, "for cause."[511] Any further extension requires the lessor's written consent.[512]

The more limited time period for assumption or rejection of real property leases eliminated the debtor's optionality, precluding debtors from keeping landlords in limbo hoping that a location might turn around if enough time elapsed. Debtors with substantial commercial leasehold interests are now required to analyze their leases in advance of filing a chapter 11 case to determine which are keepers, which are losers, and which are on the margin. Generally, only those locations on the margin should pose a problem for the debtor, requiring at least the additional 90-day extension for cause and, if possible, the consent of the landlord to further extend the time period for assumption or rejection.[513] 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 they likely will not consent to extending the time for the below-market long-term leases that many older retail chains possess. Unless a lease has inherent value because its rent is below-market or it is in a prime location, debtors generally will choose to cut their losses on any location that is only marginally profitable, and/or has been trending downward, given the substantial savings from breaching a lease in rather than out of bankruptcy.

This reduced time-frame for assumption/rejection decisions posed particular challenges for retail debtors in the context of the 2020 coronavirus pandemic given the degree of uncertainty in the retail market and the lack of adequate time to engage in advance planning early in the crisis. In a controversial decision in the *Pier 1* bankruptcy, justified in light of the pandemic circumstances, a bankruptcy court permitted a debtor to remain in possession of its leased stores beyond the section 365(d)(4) deadline without the written consent of the lessor.[514] This

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[511] 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").

[512] 11 U.S.C. § 365(d)(4)(B)(ii).

[513] A debtor may also reject a previously assumed commercial property lease after this time period lapses, but will bear an administrative expense equal to two years' worth of rent. 11 U.S.C. § 503(b)(7).

[514] Transcript, *In re Pier 1 Imports, Inc.*, No. 20-30805 (Bankr. E.D. Va. June 1, 2020), ECF No. 736.

followed another set of controversial decisions in retail bankruptcies that generously construed landlord protections in the Bankruptcy Code in favor of debtors due to the pandemic.[515] In December 2020, Congress extended the initial 120-day period to 210 days, but only until December 2022. Given this limited Congressional relief, courts are unlikely to continue to afford debtors additional relief beyond the scope of the express statutory provision.

The need to act quickly on assumption/rejection decisions puts a premium on thorough preparation and analysis of what in many cases is a large number of complex assets. As a result, potential acquirors may choose to negotiate a stalking-horse bid with the debtor before the bankruptcy filing in order to gain the opportunity to analyze the company's commercial leases before the 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 in bankruptcy by section 365(f)(1) of the Bankruptcy Code. This Bankruptcy Code provision overrides both express anti-assignment provisions as well as provisions, such as continuous operation covenants (commonly known as "go darks"), which, if enforced, could have the practical effect of precluding assignment.[516] The ability to override contractual anti-assignment provisions is a powerful tool in a debtor's arsenal to monetize its assets.[517]

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[515] *See generally* Scott K. Charles et al., Wachtell, Lipton, Rosen & Katz, *Update on COVID-19 Impacts on Landlords of Retail Debtors* (May 18, 2020), www.wlrk.com/webdocs/wlrknew/ClientMemos/WLRK/WLRK.26956.20.pdf.

[516] 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).

[517] 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

There is an express exception to this general rule negating anti-assignment provisions that 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 other party to refuse to accept performance from, or render performance to, an entity other than the debtor.[518] 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.[519]

(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 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

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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.

[518] 11 U.S.C. § 365(c)(1)(A).

[519] *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 Ent., Inc.*, 269 B.R. 311, 314-19 (Bankr. D. Del. 2001) (federal law permits assignment of exclusive copyright licenses regardless of counterparty consent).

exclusivity"[520] and "tenant mix or balance."[521] 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.[522] 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.[523]

While the Bankruptcy Code does not define the term "shopping center," courts regularly use a multifactor test that the Third Circuit articulated to determine whether leased premises are in a shopping center.[524] The most important factors to

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[520] 11 U.S.C. § 365(b)(3)(C).

[521] 11 U.S.C. § 365(b)(3)(D).

[522] One interesting question that emerged out of the *Sears* bankruptcy is whether section 365, which generally allows for the assignment of a lease notwithstanding certain lease terms to the contrary, may actually in some situations prohibit an assignment that would otherwise be permitted under the lease and nonbankruptcy law. During its bankruptcy, Sears assigned its rights to a valuable lease with the Mall of America Corporation ("MOAC") to the purchaser of substantially all of its assets, Transform. MOAC sought to block the assignment, arguing that under the statutory protections provided to shopping center landlords, Transform had not given adequate assurance because it did not have similar "financial condition and operating performance," as required by section 365(b)(3)(A), to those Sears had at the time it entered into the lease. The bankruptcy court permitted the assignment, noting that the lease permitted assignment to a party with only $50 million in net equity, and held that the shopping center protections should be interpreted "in light of what the parties actually agreed to and determined was relevant to the right to assign." *In re Sears Holding Corp.*, No. 18-23538 (Bankr. S.D.N.Y. Oct. 16, 2019), ECF No. 5393. On appeal, in a decision since vacated on other grounds, the district court disagreed, holding that MOAC was entitled to an assignee that "'looked,' in terms of its financial condition and operating performance, like the party that was vacating the premises," notwithstanding the terms of the lease. *MOAC Mall Holdings, LLC* v. *Transform Holdco, LLC (In re Sears Holding Corp.)*, 613 B.R. 51 (S.D.N.Y. 2020), *vacated on rehearing*, 616 B.R. 615 (S.D.N.Y. 2020), *aff'd*, 2021 WL 5986997 (2d Cir. Dec. 17, 2021).

[523] *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).

[524] *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

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."[525]

8. Another Chapter 11 Plan Benefit—Tax-Free Reorganizations

One of the advantages of restructuring debt in bankruptcy is the ability to qualify, in certain circumstances, 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"[526] to transfer assets in a tax-free reorganization where the acquiror issues stock or securities as consideration.[527] 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, the shareholders of the target company must maintain "continuity of interest." This means that a substantial part of the consideration received by the target shareholders must consist of stock of the surviving entity.[528] Even though, as a general rule, creditors may satisfy the continuity of interest requirement, 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.[529] 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 is for trade or other short-term debt.

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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.*

[525] *In re Ames Dep't Stores, Inc.*, 348 B.R. 91, 95 (Bankr. S.D.N.Y. 2006) (citation and internal quotation marks omitted).

[526] "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. 26 U.S.C. § 368(a)(3)(A).

[527] *See id.* § 368(a)(1)(G).

[528] *See generally id.* § 1.368-1(e).

[529] *See* 26 U.S.C. § 354(a). *See also* Part I.B.2.b.viii.

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.[530] 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.[531]

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.C.1.e of this outline.

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 and thus, will recognize CODI to the extent that the fair market value of the stock is less than the amount of debt exchanged therefor.[532] If a company is a debtor in a chapter 11 case or insolvent, however, its CODI is excluded from its income and thus is not taxable.[533]

9. Finality of Confirmation Orders—The Cost of Bonding an Appeal and The Doctrine of "Equitable Mootness"

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.[534] 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. However, it is common for the bankruptcy court to reduce or waive the 14-day period, and plans often become effective within a few days of confirmation.[535]

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[530] *See* 26 U.S.C. § 356.

[531] *See id.* § 354(a)(2)(B); *see also* 26 C.F.R. § 1.446-2.

[532] *See* 26 U.S.C. § 61(a)(11), also discussed in Part I.A.2.b and Part I.B.2.b.viii of this outline. *See also* 26 U.S.C. § 108(e)(8).

[533] *See id.* § 108(a), also discussed in Parts I.A.2.b and I.B.2.b.viii of this outline.

[534] Fed. R. Bankr. P. 3020(e).

[535] Fed. R. Bankr. P. 9006(b)-(c).

To secure a stay of a confirmation order, the appealing party generally will be required to post a bond.[536] 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 required 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 new equity in the capital markets. When calculating the amount of the bond, courts have included as possible costs of delay the accrual of interest on postpetition debt and additional professional fees,[537] as well as various forms of consequential damages, most notably opportunity costs to creditors whose distributions would be delayed.[538] The cost of bonding an appeal from a confirmation order can be prohibitively expensive, and thus frequently

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[536] 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). This includes the U.S. Trustee, which has recently been actively pursuing appeals in large chapter 11 cases, including opposition to third party releases in the *Purdue Pharma* case. *See* Suppl. Br. of Appellant, William K. Harrington, U.S. Trustee, No. 21-7532 (S.D.N.Y. Dec. 6, 2021), ECF No. 141.

[537] *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 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), *appeal dismissed and stay vacated*, 2007 WL 7706743 (2d Cir. Feb. 7, 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).

[538] *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).

presents a dilemma for the appellant, as it may not be economically rational in comparison to the probability-weighted benefit to a successful appeal.

The experience of the bondholders in the *Adelphia* bankruptcy illustrates the extreme difficulty that the bond requirement poses for an appeal of a confirmation order. In that case, a group of bondholders with approximately $1 billion of the debtor's $5 billion in notes and debentures unsuccessfully objected to confirmation of the plan.[539] 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 argued that such a high bond amount was tantamount to 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."[540] 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 amount. After the appellants offered to post only $10 million, the court vacated the stay and the plan became effective.[541]

Nevertheless, the bondholders attempted to proceed with their appeal on the merits even after the plan became effective. The district court—noting 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"—dismissed the appeal, concluding both that the bondholders were estopped from asserting that their appeal was not moot[542] and that, even if they were not so estopped, the effectiveness and consummation of the plan had rendered their appeal "equitably moot."[543]

"Equitable mootness" is a doctrine that can provide a significant advantage to a successful plan proponent. Implementation of a plan often involves complex

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[539] *ACC Bondholder Group* v. *Adelphia Commc'ns Corp. (In re Adelphia Commc'ns Corp.)*, 367 B.R. 84 (S.D.N.Y. 2007).

[540] *Id.* at 89 (emphasis in original).

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

[542] 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.

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

transactions that, once done, are difficult to undo as a practical matter. 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.[544] The Second Circuit has gone even further, finding that an "appeal is presumed equitably moot where the debtor's plan of reorganization has been substantially consummated."[545] In the Second Circuit, where the standard of review for equitable mootness determinations made by district courts is "abuse of discretion," parties face a difficult path in appealing a substantially consummated plan.[546]

However, certain appellate court decisions have called the doctrine of equitable mootness into question. One Third Circuit judge has 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

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[544] *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).

[545] *In re Charter Commc'ns, Inc.*, 691 F.3d 476, 482 (2d Cir. 2012). This presumption can be overcome only 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 also 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 court of appeals, 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).

[546] *Id*. at 483.

"abdication" of appellate jurisdiction.[547] Also, in the appeal of the *Purdue Pharma* confirmation order, the parties signed a stipulation[548] agreeing not to argue equitable mootness after the district court stated[549] that she had "no intention of allowing the critically important issues on appeal to be equitably mooted."[550]

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. As a result, the mere confirmation of certain plans may effectively immunize them from review.

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 the plan's agreed treatment of particular creditors or creditor groups. Various legal controversies

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[547] *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).

[548] *See* Amended Stipulation, *In re Purdue Pharma L.P.*, No. 21-7969 (S.D.N.Y. Oct. 20, 2021), ECF No. 58 ("The Parties shall not at any time argue before any court that the pending appeals . . . of the [Confirmation Order] have been rendered equitably moot by the actions undertaken in advance of the Effective Date in furtherance of carrying out the Plan pursuant to the Confirmation Order.").

[549] Temporary Restraining Order Pending Argument on the United States Trustee's Motion for a Stay, *In re Purdue Pharma L.P.*, No. 21-7969 (S.D.N.Y. Oct. 10, 2021), ECF No. 32.

[550] The district court subsequently vacated the confirmation order on the grounds that the nonconsensual nondebtor releases contained in the plan exceeded the bankruptcy court's statutory authority. See Decision and Order on Appeal, In re Purdue Pharma L.P., No. 21-7969 (S.D.N.Y. Dec. 16, 2021), ECF No. 164. That decision is currently on appeal to the U.S. Court of Appeals for the Second Circuit. *See In re Purdue Pharma L.P.*, No. 22-0085 (2d Cir. Jan. 27, 2022) (granting leave to appeal and request to expedite).

have arisen over the years with respect to the enforceability and propriety of restructuring support agreements.

The source 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 a disclosure statement has been approved as containing adequate information to allow creditors to cast an informed vote.[551] 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).[552] Prepackaged plans of reorganization have a statutory exception to this rule that permits votes to be solicited without a disclosure statement if they are cast *before* the bankruptcy filing.[553] While votes cast *after* the filing are not similarly authorized, postpetition solicitation of votes is permitted so long as the solicitation of the claim holder commenced before the bankruptcy filing and was in compliance with any applicable law (presumably the federal securities laws).[554]

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.[555]

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[551] *See* 11 U.S.C. § 1125(b).

[552] *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).

[553] *See* 11 U.S.C. § 1126(b).

[554] *See* 11 U.S.C. § 1125(g); *see also, e.g.*, *In re CIT Grp. Inc.*, 2009 WL 4824498, at *3-4 (Bankr. S.D.N.Y. Dec. 8, 2009).

[555] 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.'").

Section 1125(g) does not, on its face, protect a restructuring support agreement if it is negotiated entirely postpetition. Nonetheless, as a practical matter, postpetition negotiation of restructuring support agreements occurs regularly.

In *In re Indianapolis Downs, LLC*,[556] the Bankruptcy Court for the District of Delaware 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.[557] 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."[558] 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.[559]

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."[560] 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."[561]

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—participants 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

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[556] 486 B.R. 286 (Bankr. D. Del. 2013).

[557] 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).

[558] *Id*. at 297 (quoting *In re Kellogg Square P'ship*, 160 B.R. 336 (Bankr. D. Minn. 1993)).

[559] *Id.*

[560] 2013 WL 3286198, at *20 (Bankr. S.D.N.Y. June 27, 2013).

[561] *Id.* at *5.

restructuring support agreement to support a different 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.

Restructuring support agreements can reflect near-global settlements with a variety of creditor groups, or, as in the 2019 bankruptcy of *PG&E*, can be used iteratively in a complex case to resolve disputes over time with individual creditors or groups. In *PG&E*, the debtors used a series of restructuring support agreements to deal with competing creditor groups one by one, guiding the case to its eventual conclusion.

- In the first months of the case, the debtors entered into plan support agreements with certain public entities, including cities and counties asserting wildfire claims.[562]

- This was followed by the debtors' entry into a restructuring support agreement with a group of holders of insurance subrogation claims. The RSA was objected to by the official committee of tort claimants and a noteholder group which was proposing a competing plan of reorganization.[563]

- Before the bankruptcy court could rule on the objected-to RSA, the debtors reached a settlement with the tort claimants committee, and then obtained approval of both the subrogation RSA and a separate restructuring support agreement with the committee.[564]

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[562] *See* Proposed Disclosure Statement for Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization at 14, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Feb. 7, 2020), ECF No. 5700.

[563] *See* Response of Official Committee of Tort Claimants to Debtors' Restated Restructuring Support . . . and Settlement Agreement with the Consenting Subrogation Claimholders, *In re PG&E Corp.*, No. 19-30088, ECF No. 4629 (Bankr. N.D. Cal. Nov. 8, 2019); *see* Part III.B.1.b.

[564] *See* Order . . . (I) Authorizing the Debtors to Enter Into Restructuring Support Agreement with the Consenting Subrogation Claimholders [. .], *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Dec. 19, 2019), ECF No. 5173; Order [. . .] Authorizing the Debtors and TCC to Enter Into Restructuring Support Agreement With the TCC, Consenting Fire Claimant Professionals, and Shareholder Proponents [. . .], *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Dec. 19, 2019), ECF No. 5174.

- Finally, the debtors entered into a restructuring support agreement with the noteholder group, which withdrew its competing plan.[565]

- The debtors obtained confirmation of their own plan, with the consent of most major constituencies, approximately 17 months after the case was filed.[566]

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.[567] 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*. The Office of the U.S. Trustee for the Third Circuit has since softened the rule slightly, noting that execution of "any agreement limiting its ability to act as a fiduciary or to consider more than one plan," is "not disqualifying per se" but instead warrants further inquiry by the U.S. Trustee before seating the creditor on a creditors' committee.[568] It is safe to say, however, that executing such an agreement reduces the likelihood that a creditor will be appointed to a creditors' committee.

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[565] *See* Disclosure Statement for Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization at 16, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. Mar. 17, 2020), ECF No. 6353.

[566] *See* Order Confirming Debtors' and Shareholder Proponents' Joint Chapter 11 Plan of Reorganization Dated June 19, 2020, *In re PG&E Corp.*, No. 19-30088 (Bankr. N.D. Cal. June 20, 2020), ECF No. 8053.

[567] *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).

[568] 3 U.S. Trustee Program Policy & Practices Manual § 3-4.3.2 (Oct. 2020), www.justice.gov/ust/file/volume_3_chapter_11_case_administration.pdf/download.

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 unsecured 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 of prepetition agreements are less certain. The agreement is unlikely to be enforceable against the debtor, who can reject any prepetition agreements. The 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.[569] Moreover, assumption of a restructuring support agreement, even if sought by a debtor, will not always be granted by a bankruptcy court,[570] and even seeking assumption of a

[569] 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. Creditors sometimes seek to have such fees and expenses paid on the eve of the company's bankruptcy filing and/or, where applicable, to incorporate such fees and expenses into the terms of DIP financing provided by such creditors (so that they are approved by the bankruptcy court and thereby become enforceable obligations of the debtor).

[570] *In re Innkeepers USA Trust*, 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

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. For this reason, debtors that file a chapter 11 petition with a restructuring support agreement in hand often seek its approval in connection with confirmation of a plan, rather than by an earlier assumption motion.[571]

C. Rights Offerings in Connection with a Plan

In a rights offering under a chapter 11 plan, a debtor offers certain creditors (or in some circumstances, equityholders), the right to purchase equity (or sometimes debt) in the reorganized debtor post-emergence. Rights offerings are an increasingly popular way to provide a capital infusion to a reorganized debtor exiting bankruptcy, employed to fund cash distributions required under the plan, pay administrative expenses of the bankruptcy, refinance DIP loans, and permit the debtor to commence its post-bankruptcy existence with adequate liquidity.

In addition to helping recapitalize the reorganized debtor, rights offerings may provide attractive opportunities for acquirors, as they create a path for creditors to obtain outsized equity positions in the reorganized debtors, in excess of their share of the claims in the bankruptcy class(es) entitled to equity in the reorganized debtor under the plan. On the other hand, excluded or non-participating creditors may ultimately receive lesser stakes than their prepetition share of debt would otherwise suggest.

There are two reasons for this potential divergence. First, because rights offerings provide creditors with the right to purchase equity, rather than directly distributing that equity, they may result in a non-ratable distribution of equity to members of a creditor class based on the willingness of individual creditors to participate. Courts have concluded that this non-ratable distribution is permissible because the creditors provide new capital upon exercising these rights, and as discussed in Part III.B.2.i, the new value exception to the absolute priority rule allows unequal distributions to creditors that provide new value to the estate.

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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.

[571] *See, e.g.*, [First Day] Declaration at Ex. B, *In Chesapeake Energy Corp.*, No. 20-33233 (Bankr. S.D. Tex. June 28, 2020), ECF No. 37.

Second, because a debtor's successful emergence may depend on its ability to successfully raise capital through a rights offering, debtors often enlist preexisting creditors, and plan supporters in particular, to serve as backstop parties to rights offerings, with those parties guaranteeing that they will purchase any equity not subscribed for by other eligible parties. In exchange, debtors pay "backstop fees" to the backstop parties, which fees are often substantial, come in various forms and may include a cash or equity premium, or the opportunity to purchase a greater-than-ratable share of the equity on offer. While there is tension between the principle of equality of distribution that is required under a chapter 11 plan and the practice of giving certain creditors a greater stake of the reorganized debtor than their prepetition holdings would otherwise allow, courts have generally concluded that these practices are permitted under the Bankruptcy Code. Under the logic of these decisions, the backstop commitment is itself a form of consideration offered to the estate, and thus the backstop agreement falls under the "new value" rubric.

Compounding the divergences from ratable distribution of equity in the reorganized debtor to fulcrum creditors, it is common for a debtor to incentivize participation in a rights offering by, for example, allowing participating creditors to purchase equity at a significant discount to the value set forth in the plan. And such discounts may be granted to backstop parties, even with respect to shares they are receiving as fees for their funding commitments.

Backstop commitments and other components of a rights offering are often negotiated before a debtor's filing a plan of reorganization. Accordingly, potential acquirors would be well served to conduct appropriate diligence and engage with debtors about the debtor's future cash needs and the prospect of a rights offering early in the proceedings, as it may provide an attractive path to obtain equity in the reorganized debtors at a discounted price.

The *Peabody Energy* case illustrates how debtors may seek to use rights offerings in connection with a plan of reorganization.[572] In *Peabody*, the debtor and certain creditors negotiated a plan of reorganization that involved two separate rights offerings, one of which[573] was challenged. In the contested rights offering (called the "Private Placement" by the *Peabody* court), certain creditor classes were able to purchase preferred stock at a 35% discount to plan value. In exchange for providing a backstop of the Private Placement, certain creditors within the class

[572] 933 F.3d 918 (8th Cir. 2019).

[573] In the uncontested rights offering, certain creditor classes were allowed to purchase common stock in the reorganized company at a 45% discount to plan value. *Id*. at 922.

were granted rights to purchase 22.5% of the preferred stock at this discounted price, in addition to their ratable share of the remaining 77.5%, and received a "Backstop Commitment Premium" and a "Ticking Premium" in the form of additional common stock, which were collectively valued at slightly over 10% of the capital amount raised through the Private Placement.[574] In addition, all creditors needed to decide whether to participate within days of the rights offering's announcement, which made it more challenging for creditors that had not been involved in developing the terms of the Private Placement to participate.

The Private Placement was challenged by a group of creditors that were not backstop parties and had not participated in the subsequent stages of the rights offering. Those creditors argued that by providing these benefits to the backstop parties, the plan improperly provided superior treatment to other creditors in their same class, thus violating 11 U.S.C. § 1123(a)(4). The Eighth Circuit disagreed. It held that the various benefits associated with the rights offering were not offered in exchange for the creditors' bankruptcy claims, but instead were "consideration for valuable new commitments" that could be distributed unequally among creditors in the same class.[575] Notably, while the Supreme Court has indicated in *LaSalle* that a market test is the appropriate method to test the adequacy of a proposed new value contribution in connection with an investment by existing shareholder,[576] the Eighth Circuit did not require a market test here, where the investors were third parties. Instead, it pointed to the debtor's board's consideration of various proposals and conclusion that this was the best among them, effectively relying on the debtor's exercise of business judgment in determining that the backstop parties' new value contribution was adequate. As a result, the objecting creditors in *Peabody* were left with significantly less than their pro-rata share of equity in the reorganized debtors following the bankruptcy.

Other plans in recent large chapter 11 cases have followed the path laid out in *Peabody*. In the *Washington Prime Group* case, for example, Strategic Value Partners ("SVP") sponsored a plan in which it received significant equity consideration in exchange for backstopping a rights offering. As a result, SVP's post-emergence share of the reorganized debtor's equity significantly exceeded its share of claims in the fulcrum security class.

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[574] *Id*. at 922-923.

[575] *Id*. at 927.

[576] The Supreme Court's holding in *LaSalle* is discussed in Part III.B.2.i.

Although these rights offerings have become increasingly common, some courts have expressed skepticism regarding the considerable benefits provided to backstop parties. In *Pacific Drilling*, the bankruptcy court ruled that there was "no legitimate justification" for a planned private placement as part of a rights offering.[577] Even after the parties excised the private placement in favor of a purely pro-rata distribution of participation rights, the court expressed "a great deal of misgivings" about approving the backstop fees, although it ultimately did so after noting that no party had objected to those fees. *Id.*

In recent years, rights offerings have also trended toward allowing participants to purchase equity at higher discounts to plan value, often in the 30-35% range, although the variance is significant.[578] Backstop fees in rights offerings have also grown significantly, averaging a robust 12.7% in 2021, versus 6.7% over the 2016-2020 period.[579] It remains to be seen whether the trend toward more favorable terms will lead to heightened judicial scrutiny.

In sum, creditors seeking to accrue equity positions in the reorganized debtor should engage early and consider whether, by backstopping a rights offering, they can provide new value sufficient for court approval of an outsized stake.

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[577] *In re Pacific Drilling S.A.*, No. 17-13193 (Bankr. S.D.N.Y. Oct. 1, 2018), ECF No. 621.

[578] *Id.*

[579] Rong Ren, *2021 Has a Record Number of Chapter 11 Rights Offerings, Direct Investments with More Than USD 30bn Invested*, DEBTWIRE, February 22, 2022.

IV.

Acquisition and Trading in Claims of Distressed Companies

Purchasing a distressed company's debt can create a number of opportunities for a potential aquiror. It can open the door to an information advantage over other potential buyers. 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 for the holder to participate in early-stage discussions and affect strategic direction if an issuer decides to enter a prepackaged or pre-negotiated bankruptcy. An existing debtholder also has advantages in the bankruptcy process, including the right to be heard in court and, for secured creditors, 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. Finally, purchase of debt can offer a profit opportunity if the acquisition is not consummated but the debt appreciates in value.

In addition to bankruptcy law considerations, trading debt claims also requires consideration of the tax, securities laws and HSR Act implications discussed below.

Part IV of this outline highlights issues for an investor to consider with respect to purchasing claims both pre- and post-bankruptcy filing. While our focus is on the investor whose goal is ownership or control of the target or its assets, many of the considerations discussed below apply to *any* investor in a distressed company's debt.

A. What Claims Should an Investor Seeking Control Buy?

1. 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 reorganized 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 seeking control to accumulate claims or interests other than just the fulcrum security. For example, the ability to ensure confirmation (or rejection) of a plan generally depends on the tally of votes of various classes. 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. For example, in the *Washington Prime Group* case, investment vehicles of Strategic Value Partners ("SVP") sponsored a plan pursuant to which the unsecured notes held by such funds received the lion's share of the equity in the reorganized company. But the plan required the company's existing lenders to agree to amend and extend their debt, effectively serving as acquisition financing for SVP. SVP's own significant position in the debt helped facilitate a consensual deal, in part by aligning incentives (the equity sponsor benefited ratably from any compensation to lenders) and in part by preventing other lenders from themselves acquiring sufficient claims to carry the lender class without SVP's vote.

Holding non-fulcrum claims also provides a would-be-acquirer with a chance to bolster its equity position in the reorganized company beyond its ratable share of the fulcrum class and/or to sweeten the pot for other non-fulcrum creditors whose support is desired, in either case by accepting equity in lieu of the cash and/or debt distributions to which non-fulcrum creditors are otherwise entitled.

Further, often there is uncertainty over which class is at the fulcrum, in addition to the possibility that the fulcrum class may change over time as the actual or perceived value of a debtor shifts during the chapter 11 case. Most recently, the *Hertz* case saw dramatic changes in securities prices over the course of its year in bankruptcy. When Hertz filed for bankruptcy toward the onset of the Covid-19 pandemic, the second- (if not first-) lien creditors appeared most likely to be at the fulcrum; when the company emerged a year later, both such classes were paid in full, in cash, and prepetition shareholders received material distributions as well. In an earlier example, for most of the nearly three years of the *LightSquared* case, most of the parties in interest (other than Harbinger Capital Partners, which owed LightSquared equity) believed that 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 did not maximize the value of LightSquared's spectrum assets. However, the deal failed to close, litigation ensued, and, in the interim, an auction of unrelated spectrum that occurred two and a half years into the case raised expectations about the value of LightSquared and precipitated a bidding war. In

the end, the substantial delay in concluding the case allowed the equity to wind up in the money. Ergen, who had made a billion dollar investment in LightSquared debt, no doubt in pursuit of a loan-to-own strategy, was cashed out.

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.

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. It is common for financial creditors to receive equity and other unsecured creditors to receive economically equivalent but different consideration (*i.e.*, cash or debt), but the debtor's liquidity and/or the overall size of the claim pool may require the equity to be spread more widely. 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."[580] 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 claims, and previously unknown claims such as environmental and tort liabilities.

2. 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.[581] Thus, although a purchaser can *block* the acceptance of a plan by a class by acquiring more than one-third in amount of the

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[580] *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).

[581] *See* 11 U.S.C. § 1126(c).

claims in that class, to acquire a control position in that class, *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.[582]

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.[583] 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: 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."[584] 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 proof of claim

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[582] 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 preferred stock, is tallied solely by reference to the vote of two-thirds in "amount" of the interests. 11 U.S.C. § 1126(d).

[583] *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).

[584] 118 F.3d at 641.

if the claim was later sold to multiple buyers.[585] It is unclear which of those multiple buyers (if any) would retain the right to vote the single claim.

Although an acquiror can, in theory, seek to maximize its influence over the voting process by buying a large number of small trade claims rather than a small number of large claims, purchasing multiple trade claims brings a significant practical burden: there is no well-developed trading market for trade claims, in part because each claim requires individual scrutiny to ensure that the claim is not burdened with potential objections to its validity or amount.

In contrast to trade claims, 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.[586] 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. A buyer of financial debt might seek to end-run the aggregation of multiple positions for voting purposes by purchasing claims through multiple entities, but the law is not well-developed on the point and there is a risk that a court might deem the claims to be held by one entity due to their common control, especially if the separate entities were created solely for voting purposes.

In short, the Bankruptcy Code's numerosity requirement can be a real impediment to the plans of entities that would otherwise seem, based on the face amount of claims, to have dominant positions. As such, it serves as a check on the efforts of

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[585] *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").

[586] *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).

would-be acquirers to obtain non-ratable benefits for themselves relative to other holders of fulcrum class claims.[587]

B. Acquisition of Claims and Participation in the Bankruptcy Case

1. Procedural Considerations

There is no provision of the Bankruptcy Code that explicitly regulates claims trading.[588] 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,[589] 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.[590] 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 acquire the claims without representations as to their validity, but generally have the advantage of either knowing with relative certainty the amount of the purchased claim that will be allowed or buying at a price that reflects the risks to allowance.[591] By contrast, purchasers of other types of claims, such as 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 be able to negotiate with their sellers for indemnity against disallowance of purchased claims but face greater uncertainty as to how much, if any, of the

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[587] For further discussion of situations in which a party may obtain non-ratable benefits in bankruptcy proceedings, see Part III.B.4.

[588] *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.").

[589] *See* Fed. R. Bankr. P. 3001(e)(2), (4).

[590] *See* Fed. R. Bankr. P. 3001(e)(1), (3).

[591] There is a robust, if not uniform across jurisdictions, jurisprudence with respect to allowance of default interest and make-whole claims in respect of financial debt, and the related risks are well understood by market players. Similarly, while issues such as lien perfection, preference and fraudulent conveyance may affect any given issuance of debt, the risks are typically transparent and assessable, based on factors such as the issuer's solvency at the time of issue or the amount of time between issuance (or receipt of guarantees or collateral) and the bankruptcy filing.

purchased claim will in fact be allowed, as such claims may be subject to significant dispute.[592]

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,[593] 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. 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."[594] 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.[595] 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.

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[592] *See* Adam Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Comm. L. 67, 86-90 (2009).

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

[594] 11 U.S.C. § 1109(b).

[595] *See, e.g.*, *In re Combustion Eng'g, Inc.*, 391 F.3d 190, 214 n.21 (3d Cir. 2004) (noting that statutory list of a "party 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).

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.[596]

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 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.[597] 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."[598]

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

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[596] *See In re O'Brien Env't 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).

[597] Other courts have considered similar objections. *See* Objection of Potential Bidder Cleveland-Cliffs Inc. to Debtor's Motion for Expedited Relief and Approving Bidding Procedures [. . .], *In re ERP Iron Ore, LLC*, No. 18-50378 (Bankr. D. Minn. Aug. 28, 2018), ECF No. 187; Objection of Generac Power Sys. Inc. [to Bidding Procedures], *In re Briggs & Stratton Corp.*, No. 20-43597 (Bankr. E.D. Mo. Aug. 11, 2020), ECF No. 367.

[598] *In re Jon J. Peterson, Inc.*, 411 B.R. 131, 135 (Bankr. W.D.N.Y. 2009).

the U.S. Trustee, in addition to the debtor. 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.[599] However, an acquiror considering this tactic should be careful to acquire a direct claim against the debtor, since a "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 any 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*

As a matter of standing, 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

[599] *See In re Fam. 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 claim); *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. at 91 (holding that since the Code expressly specifies that a creditor is a "party in interest," when claims were purchased is "of no consequence").

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.[600] There is very little guidance on the subject 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 where there is no other choice. 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.

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.

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[600] 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.

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[601] 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 party to a total return swap does not have a direct claim against the debtor,[602] 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 referenced debt instrument.

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[601] 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).

[602] *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).

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. On occasion, putative holders of debt claims against firms seeking to reorganize 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. This happens more often than is publicly disclosed, and is generally resolved privately between the debt owner and the broker.

It is also possible for an investor to purchase a claim, generally in a securitized transaction, that exposes it to the credit risk of a given debtor but does not make it a direct creditor of the debtor and able to participate in the bankruptcy case. Commonly, real estate lenders transfer interests in mortgage loans to trusts (often, a real estate mortgage investment conduit or "REMIC") which issue securities representing beneficial interests in these trusts to investors in the secondary mortgage market. In *Innkeepers*, Appaloosa Investment L.P. held interests in a trust that owned Innkeepers debt and sought to object to the debtor's proposed procedures for selling substantially all of its assets. But Judge Chapman concluded that Appaloosa had no relationship with Innkeepers that would confer standing on Appaloosa to object, and that only the trust's duly appointed servicer could speak for the loans held by the trust.[603] The problem of lack of individual standing is often compounded in connection with securitization vehicles by the complex and arcane rules governing the trusts, their servicers and which trust securityholders may direct them.

3. 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 large chapter 11

[603] *See In re Innkeepers USA Tr.*, 442 B.R. 227 (Bankr. S.D.N.Y. 2011).

case.[604] 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.

Service on an official 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.C.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

[604] The Small Business Reorganization Act went into effect in February 2020, creating "subchapter V" a means for small businesses to reorganize under chapter 11 without, among other things, an official committee of unsecured creditors in most cases. *See* Small Business Reorganization Act of 2019, Pub. L. No. 116-54, 133 Stat. 1079 (passed Aug. 23, 2019). This outline focuses on the dynamics in large chapter 11 cases and, therefore, the provisions of subchapter V are generally beyond its scope.

unsecured creditors' committee. And in several chapter 11 cases, such as *Pliant* in 2009,[605] U.S. Trustees have agreed to appoint such creditors to the committee.

A particularly stark illustration of the advantages and disadvantages of serving on a creditors' committee took place in the bankruptcy proceedings of Neiman Marcus Group, Inc. Marble Ridge Capital, a fund that had, prior to Neiman's bankruptcy, vocally opposed a prepetition transaction involving a then-Neiman Marcus subsidiary, MyTheresa, gained appointment to the creditors' committee and was elected co-chair.[606] Through its participation on the creditors' committee, it was able to exert significant influence on the committee's investigation of the MyTheresa transaction and the course of the bankruptcy case. Eventually, a settlement of the MyTheresa claims, involving the return of some of MyTheresa's stock to unsecured creditors took shape, and Marble Ridge proposed to purchase the shares from unsecured creditors who would rather receive cash than illiquid stock.[607]

Once the potential for purchasing MyTheresa stock from other unsecured creditors became apparent, another market participant became interested in making a competing offer.[608] As detailed in a criminal complaint filed in the Southern District of New York, upon learning of the competing bid from counsel to the creditors' committee, Marble Ridge's principal threatened to pull his fund's business from the potential bidder unless it refrained from making a competing offer, and the potential bidder complied, thereby harming the unsecured creditors to whom Marble Ridge owed a fiduciary duty by its service on the committee.[609] Marble Ridge's principal was charged with and pleaded guilty to a bankruptcy crime, eventually serving time in prison.[610]

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[605] *Compare* Appointment of Official Comm. of Unsecured Creditors, *In re Pliant Corp.*, No. 06-10001 (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 (Bankr. D. Del. Mar. 9, 2006), ECF No. 314 (listing Sun Chemical Corp. and Oxy Vinyls, LP as creditors holding secured claims).

[606] Complaint ¶ 13.h, *United States* v. *Kamensky*, No. 21-cr-67(S.D.N.Y. Sep. 2, 2020), ECF No. 1.

[607] *Id.* ¶ 12.f.

[608] *Id.* ¶ 14.b-d.

[609] *Id.* ¶ 14.e-g.

[610] Tr., *United States* v. *Kamensky*, No. 21-cr-67 (S.D.N.Y. Feb. 17, 2021), ECF No. 18.

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, other constituencies may file a motion requesting that the bankruptcy court order appointment of additional committees, to ensure adequate representation of creditors or equity holders. Courts will appoint additional official committees 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).[611] These ad hoc committees have no statutory entitlement to reimbursement of the costs of counsel or professional advisors; they may, however, seek such reimbursement under either (i) the terms of a cash collateral order if the relevant debt is secured or (ii) 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.[612]

The typical chapter 11 debtor is insolvent to a greater or lesser degree. As such, the appointment of an equity committee is rarely warranted. However, in cases where the debtor is arguably on the cusp of solvency, some bankruptcy courts have recently been more open to the possibility of appointing an equity committee.[613]

4. Rule 2019—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

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[611] *See* 11 U.S.C. § 1114(d).

[612] 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. *Elliott Mgmt. Corp. (In re Lehman Bros. Holdings Inc.)*, 508 B.R. 283 (S.D.N.Y. 2014).

[613] *See, e.g.,* Order Granting Motion to Appoint Equity Committee, *In re Pyxus Int'l, Inc.*, No. 20-11570 (Bankr. D. Del. 2020), ECF No. 196; Stipulation & Agreed Order Resolving Ad Hoc Equity Committee's Motion for Entry of an Order Establishing An Official Committee of Equity Interest Holders Pursuant to 11 U.S.C. § 1102(a)(2), *In re J.C. Penney Co., Inc.*, No. 20-20182 (Bankr. S.D. Tex. 2020), ECF No. 1542.

potential securities law issues raised by joint action,[614] but also of disclosure requirements imposed by Bankruptcy Rule 2019.

Rule 2019 requires any "entity" or "committee" (including counsel) that represents 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 disclosable economic interests. "Disclosable economic interests" are defined to include, among other things, claims, derivative instruments, options or "any other right or derivative right granting the holder an economic interest that is affected by the value, acquisition, or disposition of a claim or interest."[615] The requirement to disclose "disclosable economic interests" was added to Rule 2019 in 2011 and was intended to "be sufficiently broad to cover any economic interest that could affect the legal and strategic positions a stakeholder takes in a chapter 9 or chapter 11 case."[616] The rule emerged in the wake of the *Adelphia* case, in which the parties (and the judge) determined that votes were being cast, and positions being adopted, that reflected undisclosed economic interests, to the detriment of the administration of the case.[617]

5. Intercreditor Issues Affecting Holders of Bank and Bond Debt 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 the credit 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

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[614] Potential securities law issues are discussed in Part IV.C.2.b below.

[615] Fed. R. Bankr. P. 2019(a)(1).

[616] Fed. R. Bankr. P. 2019 advisory committee's note to 2011 amend. Subdiv. (a).

[617] *See* James M. Shea, Jr., *Who Is at the Table? Interpreting Disclosure Requirements for Ad Hoc Groups of Institutional Investors Under Federal Rule of Bankruptcy Procedure 2019*, 76 Fordham L. Rev. 2561 (2008), https://ir.lawnet.fordham.edu/flr/vol76/iss5/8.

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 can limit or alter the rights of junior creditors in meaningful ways.

6. Enforcement Rights of Bank Agent Versus Lender

A syndicated credit facility typically provides for the appointment by the lenders of an administrative agent who is authorized to act on their behalf. Under New York law, which governs the vast majority of syndicated U.S. credit agreements, an individual lender does not have the right to sue the borrower to enforce its rights under the credit agreement unless the credit agreement specifically provides for such an individual right of action.[618] New York law considers individual creditor action to be precluded by typical credit agreement language, which authorizes the administrative agent, acting upon the instructions of lenders holding a certain percentage of the debt (typically a simple majority), to declare the loan accelerated and pursue remedies against the borrower in an event of default.[619] This inability of the individual lender to act persists even after the maturity of the loan or the bankruptcy of the borrower.

Accordingly, would-be acquirers may find it useful to own, or at least to ally with holders of, a majority of the loans. While a majority position alone is insufficient to ensure acceptance of the plan by the class, which requires two-thirds in amount, it does endow the holders with the ability to cause the administrative agent to take positions in court, which can put more heft behind the applicable position than were it limited to an individual lender. Perhaps most critically, a majority of lenders arguably can instruct the agent to credit bid all of the debt in a sale of the assets that secure the loan.[620] Or, put another way, to drag fellow lenders—willingly or not—into the purchase of the debtors' assets in exchange for debt on terms dictated by the majority. This strategy, which has had some success in recent cases, has also been called into question, as it arguably deprives the minority holders of protections afforded by the chapter 11 voting requirements.

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[618] *See Beal Sav. Bank* v. *Sommer*, 865 N.E.2d 1210, 1218 (2007).

[619] *See id.*

[620] *See* discussion in Part III.A.6.

7. Allocation of Enforcement Rights Between Indenture Trustee and Bondholders

The appointment of an indenture trustee pursuant to a bond indenture is mandated by the Trust Indenture Act (which regulates contractual terms of publicly issued debt securities issued in amounts greater than $10 million) and is customary for unregistered notes as well. As a baseline rule, the TIA (and most indentures by their express terms) provides that holders of not less than a majority of the principal amount of securities have the power to direct the trustee to enforce the noteholders' rights, exercise noteholders' remedies and 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. 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 bank credit agreement, a typical indenture provides individual noteholders with the ability to pursue certain remedies on their own, albeit in very limited circumstances. The TIA also 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 (as opposed to with respect to the entire issue), with certain limited exceptions,[621] though the right is of limited utility once the note issuer has entered bankruptcy and the automatic stay takes effect.

8. Intercreditor Agreements and Further Constraints on Creditor Action

Capital structures with multiple tiers of debt have become increasingly common, and intercreditor agreements are often used to govern the relationships among secured creditors at various levels of seniority. As a result, when considering an

[621] 15 U.S.C. § 77ppp(b).

investment in debt of a borrower whose capital structure includes multiple layers of secured debt, it is important for a potential investor to familiarize itself with the terms of the intercreditor agreement.

a. *Basics of Intercreditor Agreements*

A first-lien lender's top priority in assessing an intercreditor agreement is 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, and 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, including prohibiting junior creditors from objecting to sales of collateral assets that are supported by the senior class.

But the core of the intercreditor agreement is always the express provisions regarding payment which provide, in one form or another, that junior creditors are not permitted to receive any payment in a liquidation or insolvency proceeding until the payment in full in cash of the senior debt. These provisions are sometimes subject to a qualification known as the "X-clause." The X-clause permits junior creditors to receive "permitted junior securities"[622] in a plan of reorganization even if the senior debt has not been paid in full in cash; for example, junior creditors may receive equity while senior creditors are paid in full—but not in cash—with take-back debt.

Unlike unsecured bondholders, which are entitled to substantially identical treatment to general unsecured creditors, a second-lien tranche will constitute a distinct class between the first-lien holders and the unsecured creditors. In a bankruptcy case, this class 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. If so, the terms of the intercreditor agreement become a critical variable for second-lien holders seeking control. The existence of the X-clause would allow the second-lien class to receive and retain equity under a plan of reorganization that does not pay first-lien lenders in full, in

[622] By way of example, the X Clause in *Dura Automotive* defined permitted junior securities as "(1) equity interests in the company… or (2) debt securities that are subordinated to all senior debt and any debt securities issued in exchange for senior debt to substantially the same extent as, or to a greater extent than, the notes and the guaranties are subordinated to senior debt under this Indenture."

cash (and such plan may, if the relevant standards are satisfied, be crammed down on the first-lien holders).

The absence of an X-clause would prohibit the second-lien holders from consenting to a plan that (1) results in a recovery for second-lien holders but (2) does not refinance the senior debt in full in cash, without first obtaining the consent of the senior class to its treatment. In practice, this dynamic gives substantial leverage to the first-lien holders in restructuring negotiations, and may mean that in order for second-lien holders to receive any recovery, they must first provide "new money" (pursuant to a rights offering or other arrangement) in an amount sufficient to refinance the first-lien debt.

b. *Enforceability 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."[623] As a result, the essential provisions of intercreditor agreements—those that establish lien priority or payment priority—are enforceable in bankruptcy.[624] 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 reorganization.[625] Such limitations may be of particular interest

[623] 11 U.S.C. § 510(a).

[624] 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).

[625] *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.").

to creditors seeking to take control through their first-lien claims, typically by forcing a quick 363 sale of their collateral, and hoping to use intercreditor arrangements to suppress objections by second-lien holders.

Often the prohibitions imposed on second-lien holders are qualified by permitting any objections or requests for relief that would be available to an unsecured creditor, as well as the grant of a junior lien on collateral on which a lien has been granted to the first lienholder as adequate protection. By affording some rights to junior lienholders, these qualifications may help the restrictions described above survive judicial scrutiny. However, they may also permit second-lien holders to circumvent the prohibitions in the intercreditor agreement by taking actions that on their face do not directly involve the shared collateral, but in reality 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."[626]

In *Boston Generating*, the court held that an intercreditor agreement 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 proceeds 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

[626] *BOKF, N.A.* v. *JPMorgan Chase Bank, N.A. (In re MPM Silicones, LLC)*, 518 B.R. 740, 751-52 (Bankr. S.D.N.Y. 2014), *aff'd*, 596 B.R. 416 (S.D.N.Y. 2019).

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 had not occurred; and (4) the second-lien lenders were on the "cusp" of a recovery and, the court found, were not engaged in obstructionist behavior in objecting to the sale.[627]

c. *Postpetition Interest, Make-Wholes, Default Interest*

Prospective buyers of debt are well advised to analyze the provisions of any subordination or intercreditor agreements prior to purchasing such claims. This is particularly true with respect to purchases of junior debt, as senior creditors' rights can eat into junior creditor recoveries.

Oversecured creditors are ordinarily entitled to postpetition interest and reimbursement of certain expenses. But the terms of the documents governing a multi-tiered lien structure also can have important ramifications for the operation of this rule. 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 the otherwise "oversecured" first-lien portion may not be entitled to postpetition interest from the debtor's estate or to treatment as an "oversecured" claim generally.[628] Thus, the first lienholders may not receive current interest payments during the pendency of the case, and instead, will have to collect such interest from the distribution to which the second-lien holders would otherwise be entitled under the plan. For this reason, among others, it is preferable (and most common) for multi-level lien structures to be documented through separate, albeit similar, security and other collateral documents.

Contractual payment 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. Such provisions arguably allow senior creditors to obtain postpetition interest or makewholes out of the subordinated creditors' recoveries even if they are unable to obtain them from the debtor.

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[627] *Bos. Generating*, 440 B.R. at 320.

[628] *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).

In a lengthy bankruptcy case, where substantial amounts of postpetition interest can accrue, subordinated creditors risk losing significant value if senior creditors prevail on this point (particularly if the default interest rate is found to apply). Make-whole payments can similarly be substantial and therefore significantly eat into junior creditors' recoveries.

C. Risks to Acquirors of Claims

1. Risks Accompanying Acquisition of Claims

This subsection summarizes some of the risks to be considered prior to and in the process of accumulating claims, emphasizing those specific to the bankruptcy process or the accumulation of large claims positions.

a. *Investment at Risk*

Although an investor's ultimate goal may be to own a controlling stake of 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. Created by a highly democratic statute that imposes notice periods and judicial review of numerous debtor decisions on top of substantial process rights for interested parties of many stripes, bankruptcy proceedings can proceed frustratingly slowly, resulting in substantial professional and other expenses of administration (at least tens, often hundreds of millions of dollars, in a case of any size) borne by the estate. Moreover, some participants may find delay beneficial and will take steps to slow 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.

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. 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 may be irrelevant to equity but can have a significant impact on 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 exact contours of that right—and in particular, the proper interest rate—remain subject to significant dispute.[629]

Oversecured creditors—*i.e.*, those with security interests in collateral worth more 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"

[629] For example, in just the last few years, courts have diverged on whether postpetition interest is payable at the contract rate or the federal judgment rate, and whether the right to postpetition interest is an individual creditor right or a class right. *Compare In re PG&E Corp.*, 610 B.R. 308, 316 (Bankr. N.D. Cal. 2019) (postpetition interest payable at federal judgment rate), *aff'd sub nom. Off. Comm. of Unsecured Creditors* v. *PG&E Corp.*, 2021 WL 2007145 (N.D. Cal. May 20, 2021), *further appeal docketed*, No. 21-16043 (9th Cir. Jun. 17, 2021) *and In re Hertz Corp.*, No. 21-50995, 2021 WL 6068390 (Bankr. D. Del. Dec. 22, 2021) (postpetition interest payable at federal judgment rate for unimpaired unsecured creditors in solvent debtor case) *with In re Ultra Petroleum Corp.*, 624 B.R. 178, 203-04 (Bankr. S.D. Tex. 2020) (postpetition interest payable at contractual default rate), *perm. app. granted*, No. 21-20008 (5th Cir. Jan. 5, 2021). *See generally In re 53 Stanhope LLC*, 625 B.R. 573, 578-79 (Bankr. S.D.N.Y. 2021) (describing various approaches taken by courts on this issue).

(*i.e.*, not subject to prepayment) or callable only with a premium.[630] Courts have consistently held that noncallable debt may be prepaid in bankruptcy,[631] and some courts have permitted such prepayment without awarding *any* damages to secured lenders if such damages are not provided for in the financing arrangement,[632] or only awarding damages on an unsecured basis.[633] 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.[634] In some cases, courts have enforced prepayment fees even absent a showing of actual damages.[635]

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[630] 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); *HSBC Bank USA, Nat. Ass'n* v. *Calpine Corp.*, 2010 WL 3835200 (S.D.N.Y. Sept. 15, 2010).

[631] *See, e.g.*, *HSBC Bank USA, Nat. Ass'n* v. *Calpine Corp.*, 2010 WL 3835200, at *3-4; *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. Dec. 24, 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 Ent. 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 Ent. Biloxi LLC*, 445 B.R. 582, 633-34 (Bankr. S.D. Miss. 2010).

[632] *See, e.g.*, *In re Vest Assocs.*, 217 B.R. at 699-700; *Shenandoah Nursing*, 193 B.R. at 774.

[633] *See In re Premier Ent. Biloxi LLC*, 445 B.R. at 646 (collecting cases); *In re Calpine*, 365 B.R. 585, 399-400 (S.D.N.Y. 2007).

[634] *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).

[635] *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 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,

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.[636] The *Momentive* decision departed from the Third Circuit's 2016 decision in *Energy Future Holdings*, which held that the debtors' decision to refinance secured debt in bankruptcy was a voluntary "redemption" subject to a makewhole under New York law.[637]

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.[638]

In a recent high-profile decision, the U.S. Bankruptcy Court Southern District of Texas concluded that a makewhole may not constitute "unmatured interest" and, as a result, is not disallowed by section 502(b)(2). The *Ultra Petroleum* court wrote

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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).

[636] *Momentive Performance Materials Inc.* v. *BOKF, N.A. (In re MPM Silicones LLC)*, 874 F.3d 787 (2d Cir. 2017), *cert. denied*, 138 S. Ct. 2653 (2018).

[637] *In re Energy Future Holdings Corp.*, 842 F.3d 247 (3d Cir. 2016).

[638] *See, e.g.*, *In re 1141 Realty Owner LLC*, 598 B.R. 534, 540-41 (Bankr. S.D.N.Y. 2019) ("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.").

that unmatured interest—disallowed by section 502(b)(2)—is "consideration for the use or forbearance of another's money, which has not accrued or been earned as of a reference date."[639] By contrast, a makewhole—even when calculated by discounting future interest payments to their present value—is a form of liquidated damages: "Instead of compensating . . . for the use or forbearance of their money, the [make-whole] compensates the [lenders] for [the debtor's] decision not to use their money. In an unfavorable market, that decision causes the [lenders] to suffer damages. The [make-whole] liquidates those damages."[640] It remains to be seen whether this view will gain traction; if so, it could significantly increase the likelihood that makewholes are paid in bankruptcy.

Finally, debtors may also seek to avoid paying makewholes by reinstating the debt at issue: in *Mallinckrodt*, a Delaware bankruptcy court held that a debtor could reinstate its secured debt without payment of a makewhole, notwithstanding language in the loan documents that purported to require payment upon a bankruptcy filing.[641] Because the Code gives a debtor the power to reinstate the original maturities of debt obligations that were accelerated as a result of defaults, provided that defaults not based on the bankruptcy itself are cured, reinstatement may allow a debtor to avoid paying a makewhole that is only triggered by its bankruptcy filing.

Overall, acquirors of debt are well-advised to consult with sophisticated bankruptcy counsel regarding the likely effect of interest and makewhole provisions in the jurisdiction(s) where the debtor is likely to file.

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 requirements for a court to approve substantive consolidation are difficult to satisfy. A proponent of substantive consolidation generally must show either that (1) prepetition, the entities for whom substantive consolidation is sought

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[639] *In re Ultra Petroleum Corp.*, 624 B.R. 178, 187 (Bankr. S.D. Tex. 2020), *perm. app. granted*, No. 21-20008 (5th Cir. Jan. 5, 2021).

[640] *Id.* at 188.

[641] *See* Transcript of Hearing, *In re Mallinckrodt plc*, No. 20-12522 (Bankr. D. Del. Nov. 5 2021), ECF No. 5220.

"disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity," or (2) "postpetition, their assets and liabilities are so scrambled that separating them is prohibitive and hurts all creditors."[642]

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 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 possibility of substantive consolidation can have a meaningful impact on the outcome of a case that should be considered by a potential acquiror of claims.

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."[643] 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

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[642] *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).

[643] *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).

transferor that might affect the transferee's rights include avoidance of claims as fraudulent transfers,[644] 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 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.[645]

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.1.d, equitable subordination is an extraordinary remedy that is available when a creditor has engaged in inequitable conduct—such as fraud—that injured other creditors.[646] 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 *Enron* bankruptcy.[647] The bankruptcy court ruled that the transferee of a claim is subject to an equitable subordination claim that

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[644] Fraudulent transfers are discussed in Part I.D.1.

[645] *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).

[646] *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)).

[647] *In re Enron Corp.*, 333 B.R. 205 (Bankr. S.D.N.Y. 2005), *vacated*, 379 B.R. 425 (S.D.N.Y. 2007).

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."[648] 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."[649] The district court pointed out that under non-bankruptcy law, transferees can enjoy greater rights than their transferor in some instances.[650] 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 long been criticized, and has not been followed by other courts, even in the Southern District of New York.[651] 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."[652] 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

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[648] 333 B.R. at 223.

[649] *In re Enron Corp.*, 379 B.R. at 439.

[650] *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).

[651] *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); *see also In re Firestar Diamond, Inc.*, 627 B.R. 804 (S.D.N.Y. 2021) ("[T]he distinction between assignments and sales that *Enron II* relies on has no discernable basis in the Bankruptcy Code or claim trading practice . . . and also rests on state law definitions, which is itself problematic in the context of federal bankruptcy law.").

[652] 736 F.3d 247, 254 n.11 (3d Cir. 2013).

preference payment,"[653] or whether the transfer took the form of an assignment or a sale.

Given the likelihood that disabilities will travel with a claim, it is advisable for a claims purchaser both to attempt to evaluate the relationship between its prospective seller and the debtor, and to seek indemnity agreements from the seller (such as an indemnity against or representation and warranty with respect to the existence of defenses to the transferred claims).

e. *Certain Tax-Related Risks*

The claims market in large chapter 11 cases is often constrained by court orders that seek to protect a debtor's net operating losses ("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.[654] In general, an ownership change occurs under section 382 if the percentage

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[653] *Id*. at 253-54.

[654] *See* 26 U.S.C. §§ 382(b) & (e)(1). Under current law, if a company has an overall built-in gain in its assets at the time of an ownership change, the annual NOL limitation may in some circumstances be increased during the five-year period following the ownership change to the extent such gains are recognized (or deemed recognized) during such period. *See id*. § 382(h); Rev. Rul. 2003-65, 2003-2 C.B. 747. In September 2019, the IRS proposed regulations that would change various aspects of these rules, including by eliminating the ability of companies to benefit from an increased limitation even if a pre-existing built-in gain is not actually recognized during the five-year period after the ownership change. *See* Regulations Under Section 382(h) Related to Built-In Gain and Loss; Notice of Proposed Rulemaking, REG-125710-18, 84 Fed. Reg. 47,455 (proposed Sept. 10, 2019) (to be codified at 26 C.F.R. pt. 1). While a full discussion of these proposed regulations is beyond the scope of this outline, if adopted in their current form, the new rules are in most cases expected to severely reduce the ability of distressed companies to utilize NOLs and other built-in losses after an ownership change. As of April 2022, these proposed regulations had not been finalized. If finalized, the regulations would become effective 30 days after publication in the Federal Register and would thus not apply to ownership changes occurring on or prior to such date. In addition, certain transactions that are still pending as of such date, including those occurring pursuant to a chapter 11 plan in which the taxpayer was a debtor on or before such date, would be "grandfathered" and could be subject to the old rules. *See* Revised Applicability Dates for Regulations Under Section 382(h) Related to Built-in Gain and Loss; Partial Withdrawal of Notice

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).[655] 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.[656]

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.[657] A "qualified creditor" is a creditor that receives stock in the reorganized debtor in satisfaction of debt either (1) held at 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.[658] 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).[659] 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.

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of Proposed Rulemaking; Notice of Proposed Rulemaking, REG-125710-18, 85 Fed. Reg. 2,061 (proposed Jan. 14, 2020) (to be codified at 26 C.F.R. pt.1).

[655] *See* 26 U.S.C. § 382(g).

[656] *See id.* § 382(g)(4)(A).

[657] 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. *See* 26 U.S.C. § 382(l)(6).

[658] 26 C.F.R. § 1.382-9(d)(1)-(2).

[659] 26 C.F.R. § 1.382-9(d)(3).

Chapter 11 debtors that wish to rely on this exception and avail themselves of the benefits of their NOLs 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 a NOL-protection order to the extent such claims endanger the debtor's NOLs.[660] 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, notwithstanding their prevalence. In *United Airlines*,[661] 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 sell-down provisions.[662] 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.

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

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[660] 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. N.D. Cal. Jan. 29, 2019), ECF No. 10.

[661] *In re UAL Corp.*, 412 F.3d 775, 778-79 (7th Cir. 2005).

[662] *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).

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.

Historically, recovery to an insider was limited to the cost at which it purchased its claims.[663] 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.[664] 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."[665] 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."[666] 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.[667] Courts have also recognized so-called "non-statutory insiders," who do

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[663] *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.").

[664] Discussed in detail in Parts I.B.3.b.ii and IV.D.1.c of this outline.

[665] *See* S. REP. NO. 95-989, at 25 (1978); H.R. REP. NO. 95-595, at 312 (1979).

[666] *See* 11 U.S.C. § 101(31).

[667] *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).

not fall within the Bankruptcy Code's enumerated categories,[668] but still are treated as insiders, triggering the longer one-year lookback period for preferences, as compared to 90 days for transactions with non-insiders.[669] A person may be deemed a non-statutory insider if its exercise of control is used to extract a better than arm's-length deal with the debtor.

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.[670]

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.[671] 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

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[668] *See U.S. Bank Nat'l Ass'n* v. *Vill. at Lakeridge, LLC*, 138 S. Ct. 960, 962 (2018) ("Courts have devised tests for identifying other, so-called 'non-statutory' insiders, focusing, in whole or in part, on whether a person's transactions with the debtor were at arm's length.").

[669] *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").

[670] *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; *see also In re Agriprocessors, Inc.*, 521 B.R. 292, 310 (Bankr. N.D. Iowa 2014) (finding lender was non-statutory insider because it "had a very close relationship and did not deal at arm's length" with debtor). *But see Luo* v. *Melinta Therapeutics, Inc.*, 2021 WL 965614, at *9 (D. Del. Mar. 15, 2021) (finding lender was not a statutory insider because it did not control the marketing process and never had the power to appoint the CEO or the board); *Capmark Fin. Grp. Inc.* v. *Goldman Sachs Credit Partners L.P.*, 491 B.R. 335, 351 (S.D.N.Y. 2013) (finding lenders were not non-statutory insiders, as a "high level of control [is] required for non-statutory insider status").

[671] *See* Part IV.B.3.

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.[672] Importantly, a court in the Southern District of New York recently concluded in *Kirschner* v. *JPMorgan Chase Bank, N.A.* that a bank loan syndicated among 70 institutional investor groups was not a "security."[673] Thus, the general consensus is that SEC Rule 10b-5 (the basis for judicial decisions 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.[674]

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[672] 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 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.

[673] 2020 WL 2614765, at *10 (S.D.N.Y. May 22, 2020) ("Plaintiff has cited no case in which a court has held that a syndicated term loan is a 'security,' . . . Plaintiff's claim of a shift in the market [is] premature at best").

[674] *See also* Part I.B.1.d (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 which it failed to disclose because issuer owed no fiduciary or other analogous duty to selling noteholders).

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. "Big boy" letters are further discussed in Part IV.C.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.

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.[675] The Third Circuit's *Papercraft* decision—which held that fiduciaries that wrongfully trade in claims risk disgorgement of profits and equitable subordination of their claims under section 510(c) of the Bankruptcy Code—is the leading case in this area.[676] In *Papercraft*, Citicorp Venture Capital ("Citicorp Venture"), 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.[677] 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).[678] At the same time, Citicorp Venture, by virtue of its board representation, received confidential, nonpublic information about Papercraft's financial stability and assets.[679]

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[675] *See* Part IV.C.2 (discussing risks to insiders who purchase claims).

[676] *Citicorp Venture Cap., Ltd.* v. *Comm. of Creditors Holding Unsecured Claims (In re Papercraft Corp.)*, 160 F.3d 982, 991 (3d Cir. 1998).

[677] *See Comm. of Creditors Holding Unsecured Claims* v. *Citicorp Venture Cap., 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.

[678] *Id.* at 492, 498.

[679] *Id.* at 492-93.

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.[680] 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 acquired as a fiduciary; and (3) without disclosure.[681] The court also emphasized that any subordination remedy must be proportional to the level of harm suffered by the creditors.[682] 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 the creditors who would benefit from the subordination.[683] On remand, the bankruptcy court held that the record supported the subordination of Citicorp Venture's claim in addition to disgorgement of profit.[684]

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,[685] 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

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[680] *Id*. at 501.

[681] *In re Papercraft Corp.*, 160 F.3d at 987.

[682] *Id.* at 991.

[683] *Id.* at 991-92.

[684] *Comm. of Creditors Holding Unsecured Claims* v. *Citicorp Venture Cap., 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).

[685] *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).

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 they are not in possession of material nonpublic information.

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 claims of improper trading (so-called "big boy" letters, which are discussed below). 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.C.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 (often referred to as "PEO" (professional eyes only) status) allows the committee to benefit from its advisors' substantive conclusions without having been directly exposed to the material nonpublic information.

It is also important for each investor to bear in mind that, notwithstanding any sunset provision in a confidentiality agreement, nonpublic information in its possession need actually become public prior to trading. For this reason it is customary for investors receiving nonpublic information to demand a right to cause their borrowers to publish material nonpublic information following a date certain.

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"[686] and are therefore "subject to the same insider trading restrictions as true insiders such as corporate directors."[687] 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.[688]

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[686] Mem. of the SEC in Support of Mot. of Fid. Mgmt. & Research Co., *In re Federated Dep't Stores, Inc.*, 1991 WL 11688857, at *5 (Bankr. S.D. Ohio Jan. 22, 1991) (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).

[687] *Id.*

[688] Since the concept of trading walls gained currency in *In re Federated Department Stores, Inc.*, 1991 WL 79143 (Bankr. S.D. Ohio Mar. 7, 1991), 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 (S.D.N.Y. Jan. 25, 2006), ECF No. 606; *In re Delta Air Lines, Inc.*, No. 05-17923 (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 (Bankr. N.D. Cal. June 26, 2001), ECF No. 1133; *In re Integrated Health Servs., Inc.*, No. 00-389 (Bankr. D. Del. May 4, 2000), ECF No. 1136.

"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 a number of bankruptcy cases. However, a trading wall may not always provide robust protection.

Typically, an order approving a trading wall involving a member of an official committee 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.

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).

c. *"Big Boy" Letters*

If an insider is a prospective trader of bank debt and 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 that it is not disclosing to the counterparty; (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.

The effectiveness of big boy letters in shielding insiders from *all* liability cannot be assured, given the general disfavor in the law for advance waiver of fraud claims. However, many standard-form bank debt trading documents contain such big boy language,[689] and these letters 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.[690] The cause of action for common law fraud requires justifiable reliance by the party claiming fraud, and an acknowledgement by a sophisticated party that it is not relying on the insider-seller for information makes it more difficult to sustain that contention.[691] Judicial analysis of "big boy"

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[689] *See, e.g.*, THE LOAN SYNDICATIONS AND TRADING ASS'N, INC., STANDARD TERMS AND CONDITIONS FOR DISTRESSED TRADE CONFIRMATIONS § 20 (Mar. 16, 2020).

[690] *See Silver Point Capital Fund, L.P.* v. *Riviera Res., Inc.*, 132 N.Y.S.3d 740 (Table) (N.Y. Sup. Ct. 2020) (finding that fraud claims were barred by a Big Boy Letter and noting it is "well settled" that a release may include unknown fraud claims), *aff'd*, 198 A.D.3d 432 (1st Dep't 2021).

[691] *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); *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). However, some courts have found that contractual disclaimers are alone insufficient to negate reliance where one party possesses "peculiar knowledge" of the facts underlying the fraud, *China Dev. Indus. Bank* v. *Morgan Stanley & Co. Inc.*, 927 N.Y.S.2d 52, 54 (N.Y. Sup. Ct. 2011), where it supplies fraudulent information in the due diligence process,

non-reliance agreements may be context dependent, however, with courts more likely to approve of agreements that indicate a greater level of specificity and where information is not peculiarly within the disclaiming party's knowledge.[692]

(ii) Are Big Boy Letters Effective Defenses to Private Securities Fraud Claims?

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."[693] 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.[694] 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); 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."[695] However, the Second Circuit Court of Appeals has upheld non-reliance agreements against challenges under section 29(a).[696]

EnSource Invs. LLC v. *Willis*, 2019 WL 6700403, at *11 (S.D. Cal. Dec. 6, 2019), or where the disclaimer was not specific enough, *Kainos Evolve, Inc.* v. *InTouch Techs., Inc.*, 2019 WL 7373796, at *3 (Del. Ch. Dec. 31, 2019) (non-reliance provision must be an "unambiguous disclaimer of reliance on statements outside the Agreement's four corners that comes from the point of view of the 'aggrieved party'").

[692] *See, e.g.*, *Lazard Frères & Co.* v. *Protective Life Ins. Co.*, 108 F.3d 1531, 1542-43 (2d Cir. 1997).

[693] *See* 15 U.S.C. § 78cc(a).

[694] *See, e.g.*, *AES Corp.* v. *Dow Chem. Co.*, 325 F.3d 174, 179-80 (3d Cir. 2003); *SLF Holdings, LLC* v. *Uniti Fiber Holdings, Inc.*, 2020 WL 6484310, at *6 (D. Del. Nov. 4, 2020) (federal securities fraud claims cannot be dismissed based solely on the presence of a contractual anti-reliance provision), *appeal argued and under submission*, No. 20-3427 (3d Cir. Dec. 13, 2021).

[695] *AES Corp.*, 325 F.3d at 183; *see also Rogen* v. *Ilikon Corp.*, 361 F.2d 260, 268 (1st Cir. 1966).

[696] *See Emergent Cap. 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). *But see IOP Cast Iron Holdings, LLC* v. *J.H. Whitney Cap. Partners*, *LLC*, 91 F. Supp. 3d 456, 478 n.23 (S.D.N.Y. 2015) (stating that if provision was a "disclaimer of reliance on all representations related to the subject of this

Even if a big boy letter cannot bar a 10b-5 claim, the letter still may help undermine the factual basis for a private securities fraud action, which requires proof of elements that generally are the same as those required for a common law fraud claim.[697] 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.[698]

(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 and transactions involving big boy letters have been the subject of significant investigation by the SEC.[699] Unlike a private litigant, the SEC is not required to prove reliance or loss causation to sustain a charge of securities fraud.[700] 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 engaged in insider trading when they purchased and sold bonds while aware of material nonpublic information acquired by serving on six creditors' committees.[701] The

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transaction, then section 5.7(a) approaches an unlawful waiver of compliance with federal securities laws").

[697] *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 et Internationale D'Investissement* v. *Maryland Natl. Bank*, 57 F.3d 146, 153 (2d Cir. 1995) (detailing the elements for common law fraud actions).

[698] *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.

[699] *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).

[700] *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).

[701] *See SEC* v. *Barclays Bank PLC and Steven J. Landzberg*, No. 07-CV-04427, S.E.C. Release No. 20132, 2007 WL 1559227 (S.D.N.Y. May 30, 2007).

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.[702] 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 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.*,[703] 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 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,[704] and the parties settled for an undisclosed amount on the 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 a second-step trade, particularly when the

[702] *See id.*

[703] 2005 WL 6194614 (S.D.N.Y. Jan. 13, 2005); Edwin D. Eshmoili, Note, *Big Boy Letters: Trading on Inside Information*, 94 CORNELL L. REV. 133, 236 (2008).

[704] *See id.*

seller knows the immediate purchaser is a trading desk or other party likely to quickly resell the security.

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, some investors may demand "comfort orders" as a condition to their participation in confidential settlement discussions. Such orders generally provide that investors participating in settlement talks will not be deemed insiders of the debtor by virtue of their participation.[705] 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 or upon the occurrence of certain events (*e.g.*, the filing of a plan by the debtor). 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 increasingly common alternative is for creditors who wish to participate in settlement negotiations without foregoing the ability to trade to sign confidentiality agreements designed to restrict trading, but only for a specified period or until the occurrence of certain events. Pursuant to such agreements, upon the relevant trigger, 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.[706] The extent and nature of the company's cleansing disclosures are often heavily negotiated in advance as creditors, wary of insider trading liability, will 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.

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[705] *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.

[706] In the *Washington Mutual* case, the bankruptcy court held that parties' knowledge regarding settlement discussions could constitute material nonpublic information, even though those discussions did not result in an agreement-in-principle. *See In re Washington Mut. Inc.*, 461 B.R. 200, 259-63 (Bankr. D. Del. 2011). This is contrary to the common understanding of what constitutes material nonpublic information in non-distressed situations.

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 includes 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."[707] 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 should 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 . . . ."[708] Other cases have held that a creditor acts in bad faith when it acts with an "ulterior motive."[709]

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: "If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster."[710]

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[707] *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.").

[708] *See Young* v. *Higbee Co.*, 324 U.S. 204, 213 n.10 (1945) (internal quotation omitted).

[709] *See, e.g.*, *In re Fagerdala USA-Lompoc, Inc.*, 891 F.3d 848, 845-55 (9th Cir. 2018); *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).

[710] *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

In applying section 1126(e) of the Bankruptcy Code, courts have eschewed clear rules in favor of a case-by-case approach.[711] 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."[712]

b. *Purchases of Claims with the Purpose of Acquiring Control*

In a well-known case from the early days of the Bankruptcy Code, *In re Allegheny International, Inc.*, Japonica Partners, an investor, bought certain of the debtor's subordinated notes after the debtor had proposed a plan of reorganization.[713] 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;

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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).

[711] *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.").

[712] *In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (citing *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-55 (Bankr. S.D.N.Y. 1995)).

[713] 118 B.R. 282 (Bankr. W.D. Pa. 1990).

- in its capacity as a plan proponent, Japonica, because it was an insider, 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.[714]

The bankruptcy court concluded that Japonica had acted in bad faith and designated its votes under section 1126(e). 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)*,[715] the Court of Appeals for the Second Circuit affirmed lower court rulings that had relied principally on *Allegheny* in holding that acquiring claims "to establish control over [a] strategic asset" constituted bad faith.[716] *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.[717]

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

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[714] *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).

[715] 634 F.3d 79 (2d Cir. 2011).

[716] *In re DBSD N. Am., Inc.*, 421 B.R. 133, 137 (Bankr. S.D.N.Y. 2009).

[717] 634 F.3d at 101-05.

company."[718] 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 acting with the purpose of effectuating a transaction for the debtor or its 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.[719] 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

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[718] *Id.* at 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).

[719] 513 B.R. 56, 89-92 (Bankr. S.D.N.Y. 2014).

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."[720] In a separate opinion, however, the court ruled that SPSO's use of a special purpose entity to circumvent the credit agreement's prohibition on assignment to DISH 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.[721]

c. *Other Motivations for Purchasing Claims That Have Been Found to Constitute "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 depends on the debtor's failure to reorganize" to constitute bad faith.[722] Courts have also 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.[723]

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[720] *Id.* at 92.

[721] *See In re LightSquared Inc.*, 511 B.R. 253 (Bankr. S.D.N.Y. 2014).

[722] *See In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-45 (Bankr. S.D.N.Y. 1995) (collecting cases).

[723] *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.").

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.[724]

(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.[725] The court found no cognizable claim of bad faith, stating that the creditor's motive was "to maximize an economic recovery, or to hedge, by owning bonds of multiple debtors in a single multi-debtor chapter 11 case."[726]

(ii) Purchasing Claims to Block a Plan Is Not Necessarily Evidence of Bad Faith

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; the Second Circuit's decision in *DBSD* remains a relative outlier thus far.[727]

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[724] *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").

[725] *See In re Adelphia Commc'ns Corp.*, 359 B.R. 54, 63 (Bankr. S.D.N.Y. 2006).

[726] *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).

[727] *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 . . .

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.[728] 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. 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.'"[729]

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,[730] such acquisitions are not immune from antitrust scrutiny. However, 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

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leaving creditors to select not the best plan but the best deal they might be able to individually negotiate.").

[728] *See In re Figter Ltd.*, 118 F.3d 635, 638-40 (9th Cir. 1997).

[729] *Id.* at 639 (quoting *In re Gilbert*, 104 B.R. 206, 217 (Bankr. W.D. Mo. 1989)).

[730] 15 U.S.C. § 18a(c)(2).

effective competitor."[731] 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*,[732] 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 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.[733]

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[731] *See In re AMERCO*, 109 F.T.C. 135, ¶¶ 21-22 (1987) (consent order containing Complaint filed June 24, 1985); *see also* F.T.C., ANNUAL REPORT FOR FISCAL YEAR ENDED SEPT. 30, 1985, at *36 (1985).

[732] 247 F. Supp. 2d 437 (S.D.N.Y. 2003).

[733] *Id*. at 455.