Strafford

Presenting a live 90-minute webinar with interactive Q&A

Liquidating Chapter 11 Cases

Formulating Liquidation Plan Strategies and Navigating Implications for Creditors

WEDNESDAY, JULY 17, 2013

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Steven B. Smith, Partner, **Edwards Wildman Palmer**, New York

Paul A. Avron, Of Counsel, **Berger Singerman**, Boca Raton, Fla.

Brent Weisenberg, Attorney, **Cooley**, New York

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10**.

Tips for Optimal Quality

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory and you are listening via your computer speakers, you may listen via the phone: dial **1-888-450-9970** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail **sound@straffordpub.com** immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

For CLE purposes, please let us know how many people are listening at your location by completing each of the following steps:

- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the SEND button beside the box

If you have purchased Strafford CLE processing services, you must confirm your participation by completing and submitting an Official Record of Attendance (CLE Form).

You may obtain your CLE form by going to the program page and selecting the appropriate form in the PROGRAM MATERIALS box at the top right corner.

If you'd like to purchase CLE credit processing, it is available for a fee. For additional information about CLE credit processing, go to our website or call us at 1-800-926-7926 ext. 35.

Program Materials

If you have not printed the conference materials for this program, please complete the following steps:

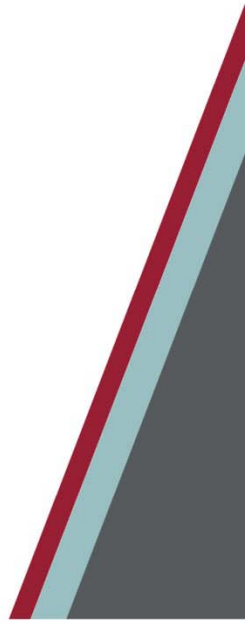
- Click on the + sign next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Liquidating Chapter 11 Cases

Presented by:

Steven B. Smith, Esq.
Edwards Wildman Palmer LLP
750 Lexington Avenue
New York, New York 10022
sbsmith@edwardswildman.com

July 17, 2013



EDWARDS
WILDMAN

Part I: Chapter 11 Liquidation vs. Chapter 7 Liquidation

Part II: Section 363 Sales vs. Liquidating Plan Sales

Chapter 11 Liquidation vs. Chapter 7 Liquidation

I. Introduction

- When a company is financially distressed, and considering its restructuring alternatives, it must decide whether it has the ability to turn the business around.

- In some cases, the company is so highly leveraged, and has so much debt, that it simply does not have the ability to reorganize.

- In such a case, the best strategy is to have an orderly liquidation to maximize the value of the remaining assets.

  - The Bankruptcy Code's ultimate goal, as it relates to businesses, is to maximize value for creditors.

I. Introduction

- Traditionally, chapter 11 of the Bankruptcy Code was used to facilitate management's rehabilitation of a troubled company, while chapter 7 offered a streamline process for liquidating a business under the supervision of an appointed trustee.
- The recent trend, however, has been for debtors to initiate liquidation through a sale under chapter 11 instead of chapter 7.
- This trend has developed because courts have allowed debtors to sell all or substantially all of their assets outside of a plan.
- What exactly are the advantages and disadvantages of liquidating assets under chapter 11 vs. chapter 7?

II. Chapter 11 Liquidation

- Chapter 11 offers an alternative to reorganization; the chapter 11 liquidation.

- Principal among the advantages it offers a business for which reorganization is an unlikely option is: **the ability of management to continue operating the business in bankruptcy**.

- The downside lies in the fact that along with continued operations come (i) increased administrative costs, PLUS (ii) the challenge of confirming a plan of liquidation.

II. Chapter 11 Liquidation

- In any liquidating Chapter 11 case, there are several milestones that must be reached to confirm a plan, maximize any distribution to creditors and stave off a potentially costly conversion to chapter 7:
  - Operations must be stabilized
  - Assets must be liquidated
  - A plan of liquidation must be confirmed
  - Claims must be evaluated and challenged, if necessary.
- We will describe – through these four milestones – the path of a successful liquidation in chapter 11.
- But first, what is a chapter 7 liquidation?

III. Chapter 7 Liquidation – What is it?

- In chapter 7 cases, a trustee:
  - is typically assigned from a panel of trustees located in the district where the bankruptcy case is filed,
  - is a private party who is not employed by the Office of the United States Trustee,

III. Chapter 7 Liquidation – What is it?

- is charged with liquidating the assets of a debtor efficiently and receives as compensation a commission on the ultimate amount of recovered, and

- distributes the liquid assets of the estate pursuant to a strict priority scheme set out in the Bankruptcy Code.

  - Section 726 governs the distribution of estate property and establishes the priority for the payment of claims (by first recognizing the priority of claims set forth in section 507).

III. Chapter 7 Liquidation – What is it?

- Loss of control of the case – i.e., avoiding the rule of unintended consequences – is one of the key reasons why corporate debtors do not often file voluntary chapter 7 cases.

- Chapter 7 creditors are usually passive and rely upon the trustee to totally administer the estate and their interest. Chapter 11 creditors, in contrast, are afforded more opportunity to assert influence and negotiate.

- One of the problems involved in filing a voluntary chapter 7 is ensuring that there are sufficient funds to support an orderly liquidation process.

  - It is likely that the process will be less orderly than filing chapter 11 and proceeding with an expeditious asset sale and a liquidation plan.

- A corporation cannot achieve a discharge of its debt in a chapter 7 case.

III. Chapter 7 Liquidation – Prominent Examples

- Prominent companies who have filed for chapter relief at the outset include: (i) the parent company of the Steak & Ale and Bennigan's restaurant chains, (ii) jewelry store operator Christian Bernard, (iii) U.S operations of designer Kira Plastinina, and (iv) the Peanut Company of America.

- Often, however, a case is converted from chapter 11 to chapter 7 where the administrative costs of chapter 11 have resulted in a scenario in which general unsecured creditors are likely to receive little or no distribution.

- The pressure to liquidate appears most widespread in the retail sector, where reorganization is especially difficult.

- Famous retail brands -- most of whom began their bankruptcy processes with the hope of reorganizing, but were quickly forced to liquidate -- include (i) Circuit City, (ii) Whitehall Jewelers, (iii) Linens 'n Things, (iv) Friedman's, Inc., (v) The Sharper Image, (vi) Boscov's, (vii) Mervyn's, (viii) Steve & Barry's and (ix) the Bombay Company.

III. Chapter 7 Liquidation – Retail Cases

- In retail bankruptcy cases, liquidations are typically accompanied by GOB sales which are most often administered by an agent hired by the debtor that guarantees the estate a certain percentage of the cost value of the debtor's inventory, with a higher recovery possible depending upon the ultimate results of the sales.

- Several companies may bid at auction for the right to be the debtor's GOB agent. The liquidator typically prices products close to retail at the start of a GOB sale, with prices reduced periodically throughout the sale term until all the inventory is sold.

- In some cases, liquidators are permitted to augment the existing store inventory with other goods.

- Once the GOB sales are completed, retail debtors in liquidation will generally auction leases and sell any remaining assets.

IV. Chapter 11 Liquidation – Retention of Management/Stabilize Operations

- The ability to retain management in place to sustain continued operations in bankruptcy is probably the most valuable distinction between chapter 11 and chapter 7.
- This ability gives the liquidating debtor a clear advantage over a chapter 7 trustee in their common goal of maximizing estate value.
- It can give the debtor the time it needs to properly market its assets without falling victim to the "garage sale" atmosphere.
- Transitioning from pre- to post- bankruptcy operations is a delicate undertaking to be sure:
  - Cash flow (which is probably already suffering) is further drained by added professional fees and a potential dip in revenue as customers turn away.
  - Employees must be paid, benefits continued, utilities provided for, and vendors appeased.

IV. Chapter 11 Liquidation – Stabilize Operations

- The debtor needs to mesh its operational needs with the requirements of the Bankruptcy Code, and they address these issues in the array of first day motions that typically accompany the filing of many chapter 11 business cases.

- Common first day orders include: (i) authorizing a debtor to honor pre-petition wages and employee benefit obligations, (ii) maintain existing bank accounts, and (iii) use of available but encumbered cash collateral.

- With these orders in place, a debtor can maintain payroll, honor employee benefits, and reassure vendors that invoices rendered post-petition will be paid.

- HOWEVER, all of this comes at a cost. In chapter 11, vendors that previously extended 30 day credit terms may insist on COD payments terms, and the expenses associated with administering a case imposes an added burden to an already stretched cash flow model.

IV. Chapter 11 Liquidation – Stabilize Operations

- In cases in which the sale of the business at a sufficient value appears likely, post-petition financing may be available to bridge the shortfall.

- In other cases, the debtor may be forced either to streamline operations and cut expenses, or accelerate the collection of outstanding receivables to generate the necessary cash flow.

- If the anticipated value to be obtained by liquidating the business in chapter 11 is insufficient to cover the added expense, chapter 7 is all but inevitable.

V. Chapter 11 Liquidation – Liquidation of Assets

- Once operations are stabilized, the next step is to market, auction and sell the assets either as a viable going concern or on a piecemeal basis.
- This stage will likely determine whether the gamble has paid off and the business will be able to realize a sufficiently high value to confirm a chapter 11 plan
- To successfully exit chapter 11 in a liquidation scenario, a debtor must realize at least sufficient proceeds to pay in full:
  - Any debts secured by the assets; and
  - All post-petition operating and administrative expenses.

V. Chapter 11 Liquidation – Liquidation of Assets

- It is critical for the liquidating chapter 11 debtor to have a good estimate of the obligations that must be satisfied to confirm a plan.

- Bankruptcy auctions typically follow a traditional format based on the solicitation of open, ascending bids (although sealed bid auctions are occasionally employed).

- There is case authority that a chapter 11 debtor should not be allowed to sell all or principally all of its business outside of a plan of reorganization. However, many courts have followed *In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983) in recognizing that a debtor may sell all or principally all of its assets outside a plan IF a sound business purpose exists for the sale (e.g., if a company has rapidly diminishing resources).

VI. Chapter 11 Liquidation – The Liquidation Plan

- While the ability to maintain operations offers a business tremendous advantages in chapter 11, the quid pro quo for this benefit lies in the requirement to solicit votes on and obtain confirmation of a plan.

- A chapter 11 liquidating plan often includes provisions for the establishment of liquidating or litigation trusts that will bring estate causes of action. BUT, a chapter 11 liquidating plan must be confirmed pursuant to the requirements of sections 1123 and 1129 of the Bankruptcy. And the requirements that must be satisfied become even more difficult to meet in a liquidation scenario.

- Notable requirements include: (i) the "best interests of creditors" test found in Bankruptcy Code section 1129(a)(7), and (ii) the "administrative solvency" test found in Bankruptcy Code section 1129(a)(9).

VI. Chapter 11 Liquidation – The Liquidation Plan

- The administrative solvency test embodies the real price of admission to chapter 11.
- Section 1129(a)(9) requires the debtor to pay, IN FULL, the "administrative expenses" incurred both in
  - operating the business post-petition; and
  - in funding the costs to administer the case
- As a result of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), administrative expenses now include claims equal to the value of goods sold in the ordinary course, and received by the debtor, within 20 days prior to the commencement of the bankruptcy case. (See Bankruptcy Code section 503(b)(9)).
- Business that rely heavily on a steady influx of raw materials or finished products could be severely impacted by these claims.

VII. Chapter 11 Liquidation – Evaluation of Claims

- To maximize distributions to creditors, the debtor and its advisors must either find more assets to distribute or render fewer creditors to share them.
- Absent competing bidders to drive up the price in an auction, there is often little a liquidating debtor can do to bake a bigger pie.
- The process of evaluating and objecting to claims can reduce the number of places at the table and have a significant impact on remaining creditors' recovery.
- That said, there is little point in aggressively pursuing claim objections under the debtor has made a determination that it can make a meaningful distribution.

VII. Chapter 11 Liquidation – Evaluation of Claims

- BUT, objections to administrative and/or secured claims should be made as soon as possible.

- Practice Tip: Simultaneously with or shortly after the filing of the bankruptcy petition, the debtor should request the setting of a **bar date** for the filing of section 503(b)(9) claims. Doing so will hopefully resolve any doubts about this component of administrative solvency before getting too far down the chapter 11 path.

- Although chapter 11 debtors frequently must waive any objections or challenges to the claims and liens of their pre-petition secured lenders -- as a precondition to the use of cash collateral – they may still have viable challenges against lenders whose consent is not required to obtain cash collateral.
- As with administrative expenses, secured claims effectively carry a dollar for dollar value in bankruptcy, so any claim that can be disallowed or reduced contributes real dollars to the potential successful confirmation of a liquidating chapter 11 plan.

VIII. Chapter 11 Liquidation – The Role of Unsecured Creditors

- The primary benefit to unsecured creditors who negotiate a distribution in a chapter 11 liquidation plan, in terms of leverage, is that they could object to the sale – which is the prerequisite to a liquidation plan.
  - They may try to negotiate a "carve-out" from the sale proceeds that would allow for some distribution to the unsecured creditors.
- Or, they could otherwise object to the liquidation plan because there is nothing in it for them.
- In many cases, the primary motivation behind a liquidation case is that the debtor's pre-petition secured lenders have decided to cut off funding, and they want their collateral to be liquidated.
- Under the foregoing scenario, the unsecured creditors can say "we are not going to cooperate with a chapter 11 case that solely benefits the secured creditor."

VIII. Chapter 11 Liquidation – The Role of Unsecured Creditors

- Some examples of cases where creditors sought to block an expedited sale in order to gain leverage include:
  - *In re Pegasus Satellite Television, Inc., et al.*, Case No. 04-20878 (Bankr. D. Me. 2004): one of the largest unsecured creditors unsuccessfully objected to the debtor's efforts to approve an expedited sale and compromise of substantially all estate assets.
- In *In re Inphonic, Inc.*, the debtor sought an expedited sale before filing a liquidation plan. The official creditors' committee filed a motion to convert the case to a chapter 7 case which ultimately led to negotiations between the parties and a carve-out of a portion of the sale proceeds for the unsecured creditors under a liquidation plan.
- In *In re Hostess Brands, Inc.*, Case No. 12-22052 (Bankr. S.D.N.Y. 2012), it was the debtor itself threatening to convert its chapter 11 case to a chapter 7 to gain negotiating leverage over their unions.

IX. Chapter 11 Liquidation – Other Creditor Complaints/Objections

- Might not accept that the debtor is continuing to operate the business.
- Management is incompetent.
- Bankruptcy case is moving to quickly (and creditors don't fully understand what their rights are or that they are being prejudiced).
  - No disclosure statement which would otherwise provide significant information on which creditors can rely in making an informed decision.
- A creditors' committee, if any, may have recently been appointed (and will not have time to properly review the debtor's financial status).
- The debtor's owners or management may be attempting to use the reorganization process to avoid having a trustee appointed and thereby hide their prior mismanagement or malfeasance.

X. Chapter 11 Liquidation vs. Chapter 7 Liquidation

- Consider the following strategy:
  - Step 1: File Chapter 11
  - Step 2: Operate the debtor as a debtor-in-possession and attempt to sell the business as a going concern for a higher value than would be realized in chapter 7; and
  - Step 3: Convert the case to chapter 7 and let a trustee administer the remaining pot of cash (thereby avoiding the time consuming and costly process of soliciting votes and confirming a chapter 11 plan.
- Research performed in 2007 (post-BAPCPA) on the relative costs, length of the process and recovery of chapter 11 liquidations vs. chapter 7 liquidations yielded interesting results. See "*Business Liquidation*," 81 Am. Bankr. L.J. 65 (2007).

X. Chapter 11 Liquidation vs. Chapter 7 Liquidation

- One study of 449 business that liquidated in bankruptcy during 1994 showed an average duration of 631 days for liquidations in chapter 7 compared to 369 days for liquidations via a confirmed chapter 11 plan.

- Converted cases (from chapter 11 to chapter 7) took an average of 1,875 days (over 5 years) to complete. The same study showed that chapter 7 cases provided an average recovery to unsecured creditors of less than 1%. In contrast, chapter 11 liquidations on average provided close to a 20% recovery to unsecured creditors.

- This research yields the following observations:

  - The file-sell-convert strategy seems less than ideal.

  - Chapter 11 liquidations appear to provide unsecured creditors with the opportunity for more substantial recoveries faster than in chapter 7.

XI. Conclusion

- The Chapter 11 liquidation plan is becoming the norm in bankruptcy cases.
- Recent case law increasingly allows for a sale of substantially all of the debtor's assets followed by a plan of liquidation
- Not every business is right for chapter 11 liquidation, and not every chapter 11 liquidation is successful.
- The key lies in determining whether the business may fetch a higher value as a going concern marketed by existing management rather than as a collection of assets sold off by a chapter 7 trustee.

XI. Conclusion

- Other more specific advantages include:
  - Increased likelihood of collecting accounts receivable while operating (resulting in higher realization);
  - Avoidance of a trustee being appointed (with its related costs);
  - Debtor has more time to operate and liquidate under less pressure;
  - If the decision is made to continue the business rather than liquidate, conversion is not necessary.
  - Potential buyers of the debtor's assets may prefer to have the acquisition "washed" through bankruptcy, so as to all but eliminate the possibility of an expected creditor turning up subsequent to the acquisition and making a claim against the purchase.

Sales Through Section 363 vs. Liquidation Plans

I. Introduction

- Bankruptcy Code Section 363 sales allow a debtor-in-possession to use, sell or lease all or substantially all of the property of the estate outside the ordinary course of business PROVIDED there is notice and a hearing of the sale.
- Section 363 sales have become an increasingly common, and controversial, method not just to reorganize financially distressed companies, but to sell entire companies and dispose of the bankruptcy without a plan.
- Section 363 offers a distressed company an efficient mechanism to obtain cash by condensing the bankruptcy process.
- BUT, a sale of the debtor's assets can also be effectuated through a chapter 11 plan of liquidation.
- This part of the presentation will focus on the advantages and disadvantages of pursing sales pursuant to section 363 vs. pursuant to a plan of liquidation.

II. Section 363 Sales vs. Plan Sales

- Section 363 sales offer great advantages but have less protection for creditors than the plan process.

- The procedure relies heavily on the debtor's judgment to asses the exigency of the situation, and puts creditors at a disadvantage because they must act quickly to successfully object to a motion for sale.

- Once a court authorizes the sale, creditors have very limited opportunity for redress because mootness operates to protect good faith purchasers and foreclose appeals.

III. Section 363 Sale Advantages: Efficient Transfer of Assets Mechanism

- Section 363 sales provide debtors a valuable and flexible tool.

- The option provides debtors the ability to quickly dispose of assets, liquidate the estate expediently, and complete the sale without a lengthy chapter 11 reorganization plan.

- The sales provide benefits to debtors by (i) allowing sales free and clear of liens under section 363(f), (ii) allowing for protections from successor liability, (iii) reducing administrative costs.

III. Section 363 Sale Advantages: Efficient Transfer of Assets Mechanism

- One of the most significant advantages of the sales is section 363(m), which statutorily moots appeals of section 363 sales.

- A quick resolution in bankruptcy offers advantages not only to the debtor, but also to the creditors.

- The sales avoid the potentially less efficient results that would be achieved through the bargaining and litigation of plan confirmation. AND, creditors forego the administrative costs of confirming a plan.

III. Section 363 Sale Advantages: Efficient Transfer of Assets Mechanism

- The Lehman Brothers bankruptcy demonstrated the necessity for the flexible, quick solution of section 363 sales.

- Lehman had no more cash; there were no more lenders; Lehman could not find a buyer; and the U.S. Government denied the company federal bailout funds.

- Lehman had no choice but to file chapter 11 and Barclay's immediately stepped in as a willing buyer.

III. Section 363 Sale Advantages: Efficient Transfer of Assets Mechanism

- Lehman's COO testified that if the sale were not approved immediately, the company would likely disappear as a going concern.

- Before approving the expedited procedure, the court addressed the due process issues, noting that heavy media coverage of the bankruptcy cases served as ample notice to creditors.

- The case represented the paradigmatic "melting ice cube" situation for which section 363(b) was intended (i.e., when the value of the debtor's assets is certain to decrease in the future).

III. Section 363 Sale Advantages: Efficient Transfer of Assets Mechanism

- The size of the assets for sale was so large that there would unlikely be another interested buyer.

- Without cash, the company could not continue, and the only alternative was immediate liquidation – which would elicit fewer funds for the estate.

IV. Section 363 Sale Disadvantages: Less Protection than a Plan

- The economic benefits of debtors quickly reorganizing are counteracted by the potential harms of creditors unwilling to lend because of the threat that speedy bankruptcies will bypass their rights.

- Criticisms of section 363 sales include:

  - The vast power afforded to large creditors and/or existing management;

  - The potential for “sweetheart deal”

- d

IV. Section 363 Sale Disadvantages: Less Protection than a Plan

- The potential for "sweetheart deal;"
- Less required disclosure than reorganization plans; and
- The circumvention of the creditor committees and their interests.

- Simply put: the procedures to approve chapter 11 plans protect creditors' rights and ensure the sanctity of the bankruptcy case.

IV. Section 363 Sale Disadvantages: Less Protection than a Plan

- Although a debtor may sell substantially all of its assets through a plan under section 1123(b)(4), most practitioners prefer section 363 sales because of the reduced time and cost.

- Since urgent sales often necessitate abbreviated notice, creditors have less time to process less information. In contrast, for a plan, disclosure statements lengthen the process BUT give creditors thorough information pursuant to the Code's mandate of "adequate information."

- Disclosures for a section 363 sale need only contain a description of the priority.

IV. Section 363 Sale Disadvantages: Less Protection than a Plan

- Section 363 sales should only provide for the transfer of assets and not dictate the terms of reorganization that would be determined by a plan. Courts call a plan disguised as a sale a "sub rosa plan." *Pension Benefit Guar. Corp. v. Brainiff Airways, Inc. (In re Brainiff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983).

- The plan confirmation process offers creditors more time to air grievances and negotiate with the debtors.

- Bidding procedures that provide the buyer (a creditor) significant benefits at the expense of other creditors would violate protections afforded in plan confirmation.

V. Section 363 Sale Procedures

- Bankruptcy Rule 6004 dictates the procedure for section 363 sales.
- The sale authorization process typically has two stages:
  - The court approves the sale and the bidding procedures; and
  - Once the auction is complete, the court approves the purchaser.
- Rule 6004 incorporates the notice procedures of Rule 2002 which requires 21 days' notice (unless shortened for cause shown)

V. Section 363 Sale Procedures

- The short time between a proposed sale and authorization can leave a creditor little time to formulate a meaningful objection.
- Disorganized creditors' committees or smaller creditors suffer from disadvantages in formulating objections.
  - Less information;
  - Less time; and
  - Possibly a geographic barrier.

V. Section 363 Sale Procedures

- A party may object to a sale order, but must do so at least seven days before the court hears a motion for sale.
- Objections might allege that:
  - The purchase price is suboptimal;
  - The purchase price does not provide adequate information under section 363€
  - Collusion exists under section 363(n); or
  - The sale constitutes a sub rosa plan.

V. Section 363 Sale Procedures

- Buyers usually request a court order for the sale with an explicit finding of good faith.

- Once a court authorizes a sale, Bankruptcy Rule 6004(h) provides an automatic 14 day stay before sale consummation, but courts almost always eliminate this stay in light of the debtor's push to complete the sale quickly.

- Section 363(m) set a clear standard that no asset can be taken back from a good faith purchaser. The provision furthers the goal of finality.

VI. Section 363 Sales: Exigency vs. Due Process

- *In re Chrysler LLC* and *In re General Motors Corp.* were cases in which the need for speed proved weightier than concerns about the sale process and creditor rights.

- Creditors were unable to appeal to a higher court their concerns that the sale (i) circumvented priorities, (ii) garnered them a sub-optimal return or (iii) constituted a sub rosa plan.

- Although these cases were exceptional, they set precedent for pushing through sales and past procedural safeguard.

VII. Section 363 Sales: Recent Cases

- Recent cases from the Bankruptcy Court for the S.D.N.Y. demonstrate the precedential value *Chrysler* and *GM* had in allowing buyers to demand a quick process.
  - *In re GSC, Inc.*, 453 B.R. 132 (Bankr. S.D.N.Y. 2011): the court relied on both *GM* and *Chrysler* to approve a quick sale of all the debtor's assets to Black Diamond.
  - *In re Bos. Generating, LLC.*, 440 B.R. 302 (Bankr. S.D.N.Y. 2010).
  - *In re Metaldyne Corp.*, 409 B.R. 671 (Bankr. S.D.N.Y. 2009) *aff'd* 421 B.R. 620 (S.D.N.Y. 2009).

VIII. Section 363 Sales: Valid Business Purpose

- Historically, courts skeptical of sales outside of chapter 11 required a showing of an emergency before approving a sale.
- Today, courts give more deference to the reorganizing company's management and only require a valid business purpose for sale.
- A valid business purpose is necessary for both the sale and not waiting for a plan to complete the sale.

VIII. Section 363 Sales: Valid Business Purpose

- *In re Lionel*, 722 F.2d 1063 (2d Cir. 1983) gave rise to the valid business purpose test. The test listed non-exclusive factors for consideration of s ale motion:
  - Proportionate value of assets to the whole business;
  - Amount of time elapsed since the filing;
  - Likelihood a plan will be proposed and confirmed in the near future;
  - Effects of proposed disposition on future plan;
  - Proceeds to be obtained; and
  - Whether the asset is increasing or decreasing in value.
- The *Lionel* factors rely on the notion that the disposition of assets is an incremental step of the plan process, not a means of disposing of the bankruptcy case altogether.

VIII. Section 363 Sales: Valid Business Purpose

- Because of the transformation in how debtors employ section 363, some courts have suggested a new set of criteria for evaluating sale motions – like *Chrysler.*

- The *GM* Court embraced the *Lionel* factors but added four additional factors:

  - Does the estate have the liquidity to survive until plan confirmation?
  - Will the sale opportunity still exist as of the time of plan confirmation?
  - If not, how likely is it that there will be a satisfactory alternative sale opportunity?
  - Is there a material risk that by deferring the sale, the patient will die on the operating table? (*In re Gen. Motors*, 407 B.R. 463, 490 (Bankr. S.D.N.Y. 2009).

IX. The Hon. D. Michael Lynn on Section 363 Sales

- The Hon. D. Michael Lynn is a United States Bankruptcy Judge in the Northern District of Texas, and he made the following comments on section 363 sales that dispose of a substantial portion of a debtor's assets at the beginning of a case in a 2011 interview he gave to the Turnaround Management Association.

- "I prefer to see the plan process be used because that process has checks and balances, as well as opportunity for fuller creditor participation, that you do not have in the early section 363 sale. However, you have to view such sales based upon two scales: are we looking at melting ice cream so that the value of the estate is likely to go down to the detriment of creditors if we don't do something quickly? If there are 40 trucks of melting ice cream and you want to sell the trucks and ice cream, that is easy."

IX. The Hon. D. Michael Lynn on Section 363 Sales

- "On the other scale, how complicated is the sale? If a debtor is selling everything and the byer is picking up the debtors' contracts and hiring all the employees, that is another story. When you have a sale that proposes to assume some claims and not others, then you have issues relating to the equal treatment of creditors." The less severe the exigencies, the more I am disinclined to approve an early sale. Also, as the sale grows more complex and the chance of loss grows less, the likelihood of a section 363 sale being allowed goes down."

- "Most of my cases are not resolved through section 33 sales. But, we do see them as a result of [BAPCPA] in retail cases, which often have to go through a section 363 or controlled liquidation sale rather than a true reorganization."

IX. The Hon. D. Michael Lynn on Section 363 Sales

- "Most of the cases in my court provide for the post sale wrap up through a plan that provides for a liquidating trustee to pursue suits, including voidable transfer suits, and to object to claims. Chapter 7, which is the other alternative, is more expensive and not subject to creditor control. In cases where a liquidating trust is established, cost-benefit analyses on the types of professional action against the likelihood of recoveries needs to be carefully looked at, but the creditors are in the best position to decide what the liquidating trustee and its professionals can do.

X. Conclusion

- Section 363 sales are an important tool in bankruptcy. The public has an interest in concluding bankruptcies quickly and efficiently.
- BUT, efficiency comes at a price – a less thorough process, creating vulnerabilities to creditors' rights.
- Congress included section 363 in recognition of the fact that plans are not always practical

EDWARDS WILDMAN

BERGER SINGERMAN
attorneys at law

Liquidating Chapter 11 Cases:

Formulating Liquidation Plan Strategies and Navigating Implications for Creditors

Presented by:

Paul Avron

Berger Singerman
2650 North Military Trail, Ste.240
Boca Raton, FL 33431
pavron@bergersingerman.com

BERGER SINGERMAN
attorneys at law

Introduction

The bulk of my presentation is taken from an article a current colleague, Paul Singerman, and a former colleague, Jonathan Brand, authored entitled "'Doing Good' in Chapter 11 Liquidating Plans" published in the December/January 2007 edition of the American Bankruptcy Institute Journal.

BERGER SINGERMAN
attorneys at law

Issue

How and what to do with unclaimed funds otherwise due to be distributed under a confirmed chapter 11 liquidating plan to creditors with allowed claims.

BERGER SINGERMAN
attorneys at law

How unclaimed funds might arise in a liquidating chapter 11 case

Situations where undistributed funds might exist five years after confirmation of a chapter 11 liquidating plan include where at that time (i) a purchaser of substantially all of a chapter 11 debtor's assets is not in existence, (ii) a debtor has been legally extinguished and the funds on hand are proceeds of litigation claims resolved after that time, or (iii) distributions are returned to the liquidating agent because the creditor moved without leaving a forwarding address and the liquidating agent cannot (or because of the *de minimis* amount of the distribution elects not to try to) locate the creditor.

BERGER SINGERMAN
attorneys at law

Applicable Statutes

(a) Ninety days after the final distribution under section 726, 1226, or 1326 of this title in a case under chapter 7, 12, or 13 of this title, as the case may be, the trustee shall stop payment on any check remaining unpaid, and any remaining property of the estate *shall be paid into the court and disposed of under chapter 129 of title 28.*

(b) Any security, money, or other property remaining unclaimed at the expiration of the time allowed in a case under chapter 9, 11, or 12 of this title for the presentation of a security or the performance of any other act as a condition to participation in the distribution under any plan confirmed under section 943(b), 1129, 1173, or 1225 of this title, as the case may be, *becomes the property of the debtor or of the entity acquiring the assets of the debtor under the plan, as the case may be*.

11 U.S.C. § 347(a) and (b) (Italics added).

Applicable Statutes (Cont'd)

If a plan requires presentment or surrender of a security or the performance of any other act as a condition to participation in distribution under the plan, such action shall be taken *not later than five years after the date of the entry of the order of confirmation.* Any entity that has not within such time presented or surrendered such entity's security or taken any such other action that the plan requires may not participate in distribution under the plan.

11 U.S.C. § 1143 (Italics added).

Neither statute provides guidance concerning whether and how unclaimed funds in a chapter 11 liquidation case remaining five years after confirmation should be distributed; however, that issue can and should be dealt with in the plan or liquidating trust agreement.

BERGER SINGERMAN
attorneys at law

Statutes References in Bankruptcy Code section 347(a)

TITLE 28, PART V – PROCEDURE, CHAPTER 129 - MONEYS PAID INTO COURT

All moneys paid into any court of the United States, or received by the officers thereof, in any case pending or adjudicated in such court, shall be forthwith deposited with the Treasurer of the United States or a designated depositary, in the name and to the credit of such court. This section shall not prevent the delivery of any such money to the rightful owners upon security, according to agreement of parties, under the direction of the court. **28 U.S.C. § 2041**

No money deposited under section 2041 of this title shall be withdrawn except by order of court. In every case in which the right to withdraw money deposited in court under section 2041 has been adjudicated or is not in dispute and such money has remained so deposited *for at least five years unclaimed by the person entitled thereto, such court shall cause such money to be deposited in the Treasury in the name and to the credit of the United States.* Any claimant entitled to any such money may, on petition to the court and upon notice to the United States attorney and full proof of the right thereto, obtain an order directing payment to him. **28 U.S.C. § 2042** (Italics added).

CHAPTER 129 - MONEYS PAID INTO COURT (Cont'd)

Except for public moneys deposited under section 2041 of this title, each clerk of the United States courts shall deposit public moneys that the clerk collects into a checking account in the Treasury, subject to disbursement by the clerk. At the end of each accounting period, the earned part of public moneys accruing to the United States shall be deposited in the Treasury to the credit of the appropriate receipt accounts. **28 U.S.C. § 2043.**

On motion of the United States attorney, the court shall order any money belonging to and deposited by or on behalf of the defendant with the court for the purposes of a criminal appearance bail bond (trial or appeal) to be held and paid over to the United States attorney to be applied to the payment of any assessment, fine, restitution, or penalty imposed upon the defendant. The court shall not release any money deposited for bond purposes after a plea or a verdict of the defendant's guilt has been entered and before sentencing except upon a showing that an assessment, fine, restitution or penalty cannot be imposed for the offense the defendant committed or that the defendant would suffer an undue hardship. This section shall not apply to any third party surety. **28 U.S.C. § 2044.**

CHAPTER 129 - MONEYS PAID INTO COURT (Cont'd)

(a) The Director of the Administrative Office of the United States Courts, or the Director's designee under subsection (b), may request the Secretary of the Treasury to invest funds received under section 2041 in public debt securities with maturities suitable to the needs of the funds, as determined by the Director or the Director's designee, and bearing interest at a rate determined by the Secretary of the Treasury, taking into consideration current market yields on outstanding marketable obligations of the United States of comparable maturity.

(b) The Director may designate the clerk of a court described in section 610 to exercise the authority conferred by subsection (a). **28 U.S.C. § 2045.**

BERGER SINGERMAN
attorneys at law

Application of Bankruptcy Code section 347(a) by default in liquidating chapter 11 case

There have been examples of cases where, despite the lack of provisions in a chapter 11 liquidating plan dealing with disposition of unclaimed funds, liquidating agents pay such funds into the court registry as contemplated by Code section 347(a) which by its terms does *not* apply to chapter 11 cases. *See, e.g., In re TLI, Inc.,* 213 B.R. 946 (N.D. Tex. 1997), *aff'd*, 159 F.3d 1355 (5th Cir. 1998) (per curiam).

BERGER SINGERMAN
attorneys at law

Providing for disposition of unclaimed funds for charitable purposes in a chapter 11 liquidating plan.

Because a chapter 11 plan, including a liquidating plan, is in essence a contract, *Ernst & Young LLP v. Baker O'Neal Holdings, Inc.*, 304 F.3d 753, 755 (7th Cir. 2001), a debtor could include a provision in a liquidating plan that unclaimed funds be given to a charitable cause. Such a provision would not implicate the provisions of Code section 1129 or appear to run afoul of Code section 1123.

Providing for disposition of unclaimed funds (Cont'd)

Local Rules of a Bankruptcy Court could facilitate this type of disposition. For example, Rule 3011-1(B)(2), United States Bankruptcy Court for the Southern District of Florida, entitled "Disposition of Unclaimed Funds Under A Chapter 11 Liquidating Plan," provides that "[a] chapter 11 liquidating plan may provide that any unclaimed funds may be redistributed to other creditors or administrative claimants *or donated to a not-for-profit, non-religious organization identified in the plan or disclosure statement accompanying the plan*." (Italics added).

BERGER SINGERMAN
attorneys at law

An example of provisions in a chapter 11 liquidating plan from the Southern District of Florida providing for disposition of unclaimed funds:

"Pursuant to Local Rule 3011-1(B), Unclaimed Property shall be donated to the Bankruptcy Bar Foundation, a not-for-profit, non-religious, organization dedicated to, among other things, promoting the pro bono legal representation of the indigent." [Chapter 11 Liquidating Plan of Levitt & Sons, LLP, *et al.*, Case No. 07-19845, ECF No. 4033, Article 7, Section 7.3 (homebuilder case)]

BERGER SINGERMAN
attorneys at law

Application of the *cy pres* doctrine:

In the absence of a Local Rule, the *cy pres* doctrine could be (and has been) employed to facilitate provision of unclaimed funds to charitable causes. The *cy pres* doctrine stems from the French Norman phrase *"cy pres comme possible,"* which means "as near as possible." *Democratic Cent. Comm. v. Washington Metro. Area Transit Comm'n* , 84 F.3d 451, 455 n.1 (D.C. Cir. 1996). This doctrine, a creature of common law, was created to assist in distribution of assets of a probate estate when a trust's original purpose failed in some respect. Federal courts have expanded the use of the *cy pres* doctrine to unclaimed or undistributed funds in class action lawsuits. For example, in *Jones v. National Distillers*, 56 F. Supp. 2d 355 (S.D.N.Y. 1999), the court applied the *cy pres* doctrine where the cost of distributions was projected to be greater than the amount of funds held in the court registry. *Id.* at 357.

BERGER SINGERMAN
attorneys at law

Application of the *cy pres* Doctrine: (Cont'd)

Some courts have deviated from the scheme provided by Chapter 129, finding that it does "not limit the discretion of the district court to control the unclaimed portion of a…judgment…." *Jones*, 56 F. Supp. 2d at 358. These courts find that Chapter 129 controls when ordered by a court or where a court fails to provide a mechanism for distribution of unclaimed funds. *Van Gernert v. Boeing Co.*, 739 F.2d 730, 735 (2d Cir. 1984). Deviating from Chapter 129 is usually premised upon equitable or economic considerations like that applied in *Jones*.

BERGER SINGERMAN
attorneys at law

Do unclaimed funds have to go to causes related to the chapter 11 case?

Consistent with the concept underlying the *cy pres* doctrine, most cases that provide for distributions of unclaimed funds require that they be given to causes related to the underlying claims in the case. *See*, *e.g.*, *Nelson v. Greater Gadsden Housing Auth.,* 802 F.2d 405, 409 (11th Cir. 1986) (in class action involving utility allowances to tenants in a public-housing complex, affirming district court order providing that the defendant use any unclaimed compensatory damages to increase the energy efficiency of the apartment units at the complex); *In re Simon II Litigation*, 211 F.R.D. 86 (E.D.N.Y. 2002) (District Court directed that unclaimed funds in tobacco class action lawsuit be "allocated by the court on a *cy pres* basis to treatment and research organizations working in the field of each disease on advice of experts in the fields"), *overruled on other grounds*, 407 F.3d 125 (2d Cir. 2005).

BERGER SINGERMAN
attorneys at law

Unclaimed funds (Cont'd)

However, many courts have authorized distribution of unclaimed funds to charitable causes unrelated to the substance of the underlying claims. *See*, *e.g.*, *Superior Beverage Co. v. Owens-Illinois*, 827 F. Supp. 477, 478 (N.D. Ill. 1993) (in allowing representatives of various charitable groups to advocate for $2 million in unclaimed funds in class action antitrust lawsuit the District Court explained that, "[i]n recent years, the doctrine appears to have become more flexible. Funds remaining in antitrust cases have been awarded to law schools to support programs having little or no relationship to antitrust law, competition, or the operation of our economy.") (citing *In re Corrugated Container Antitrust Litigation, MDL # 310,* 53 Antitrust & Trade Regulation Reports 711 (S.D. Tex. Oct. 6, 1987)). *Accord In re San Juan Dupont Plaza Hotel Fire Litigation*, 687 F.Supp.2d 1, 2-3 (D. Puerto Rico 2010) (District Court explained that "while use of funds for purposes closely related to their origin might be the best application, the *cy pres* doctrine and the courts' broad equitable powers now permit use of these funds for other public interest purposes by either educational, charitable, or other public service organizations, both for current programs or to constitute an endowment and source of future income for long-range programs."); *see generally In re Motorsports Merch. Antitrust Litig.,* 160 F. Supp. 2d 1392, 1394 (N.D. Ga. 2001) (collecting cases where *cy pres* funds were distributed to charitable organizations unrelated to original claims).

BERGER SINGERMAN
attorneys at law

We're not talking chump change!

The amount of cy pres awards can be substantial: *In re Infant Formula Multidistrict Lit.,* 2005 WL 2211312, *2-3 (N.D. Fla. 2005) ($1,010,073.17 unclaimed funds donated to the American Red Cross); *Schwartz v. Dallas Cowboys Football Club, Ltd.,* 362 F. Supp. 2d 574, 576-77 (E.D. Pa. 2005) ($436,000 donated to NFL Youth Education Town Centers); *In re Motorsports Merch. Antitrust Litig.,* 160 F. Supp. 2d 1392, 1394 (N.D. Ga. 2001) ($2.4 million of unclaimed settlement funds donated to nine charities); *In re Mexico Money Transfer Litigation,* 164 F. Supp. 2d 1002, 1031-34 (N.D. Ill. 2000) ($4.6 million donated to charities); *In re Toys 'R' Us Antitrust Lit.,* 191 F.R.D. 347, 353-54 (E.D.N.Y. 2000) (donating toys worth $36.6 million to children's charities); *Powell v. Georgia-Pacific Corp.,* 119 F.3d 703 (8th Cir. 1997) ($1 million donation to scholarship funds); *Superior Beverage Co. v. Owens-Illinois*, 827 F. Supp. 477 (N.D. Ill. 1993) ($2 million donated to fourteen non-profit legal groups, law schools and an art museum); *In re "Agent Orange" Prod. Liab. Lit.,* 611 F. Supp. 1396 (E.D.N.Y. 1985), *aff'd in relevant part,* 818 F.2d 179 (2d Cir. 1987) ($45 million *cy pres* award).

BERGER SINGERMAN
attorneys at law

Conclusion

In the absence of a local rule of a Bankruptcy Court, chapter 11 debtors and their professionals should cite to and rely on the Court's equitable powers under Code section 105(a) and the *cy pres* doctrine to facilitate distribution of unclaimed funds to any of the numerous worthwhile charitable causes that abound, and do so through a liquidating plan to bind creditors and parties-in-interest, regardless if they vote to confirm.

Formulating, and Obtaining Approval, of a Plan of Liquidation

Presented by:

Brent Weisenberg
Cooley LLP
1114 Avenue of the Americas
New York, NY 10036
bweisenberg@cooley.com

July 17, 2013

attorney advertisement

Cooley

Three Steps Toward Plan Confirmation

Cooley LLP

1) obtain Court approval of disclosure statement
   - purpose is to provide adequate information about Plan so that creditors can vote

2) obtain consent of requisite (by number and dollar amount) creditors through balloting

3) obtain Court approval of Plan at confirmation hearing

Chapter 11 Liquidating Plans

Cooley LLP

- Liquidating Plans are permissible in chapter 11 cases
- Allow debtor to liquidate business under more economically advantageous circumstances than chapter 7 liquidation
  - Some studies indicate that chapter 11 liquidations provide greater return in shorter period of time than chapter 7 liquidations
- Permit creditors to take more active role in fashioning liquidation of assets and distribution of proceeds than in chapter 7

Confirming a Plan

Cooley LLP

After balloting, Court will conduct hearing to determine if Plan meets requirements of Section 1129 of Bankruptcy Code. These require findings – by a preponderance of the evidence – that:

1) Plan complies with requirements of Title 11
   - Provision encompasses requirements of Sections 1122 and 1123 of Bankruptcy Code governing classification of claims and contents of a Plan, respectively
     - For a classification structure to satisfy Section 1122, not all substantially similar claims or interests need to be designated in same class. Instead, claims or interests designated to a particular class must be substantially similar to each other
     - Section 1123(a) sets forth seven requirements with which every chapter 11 Plan must comply. Section 1123(b) lists discretionary provisions

Section 1129 Requirements

Cooley LLP

2) Proponent of Plan complies with applicable provisions of Bankruptcy Code

- Provision is intended to encompass disclosure and solicitation requirements under Sections 1125 and 1126 of Bankruptcy Code
  - Under Section 1126(c) of Bankruptcy Code, entire class of claims is deemed to accept Plan **if** Plan is accepted by creditors that hold at least **two-thirds in dollar amount** and more than **one-half in number** of allowed claims in class
  - Under Section 1126(f), holders of unimpaired claims are deemed to have accepted Plan

Section 1129 Requirements *(continued)*

Cooley LLP

3) Plan has been proposed in good faith and not by any means forbidden by law
   - Good faith means there is reasonable likelihood that Plan will achieve a result consistent with objectives and purpose of Bankruptcy Code
4) Any payment made or to be made under Plan has been approved by, or is subject to approval of, Court as reasonable
5) Plan Proponent has disclosed identity and affiliations of any individual proposed to serve as director, officer, or voting trustee of Debtor and that appointment to, or continuance in, such office of any such individual is consistent with interests of creditors and equity security holders and with public policy
6) Plan Proponent has disclosed identity of any Insider that will be employed or retained by reorganized Debtor, and nature of any compensation for such Insider
7) No governmental regulatory commission exists with jurisdiction, after confirmation of Plan, over rates of Debtor

Section 1129 Requirements *(continued)*

Cooley LLP

8) If there are impaired classes of claims, court cannot confirm Plan unless it has been accepted by at least one class of non-insiders who hold impaired claims

9) Each holder of impaired claim or interest voting will receive or retain under Plan property of a value, as of effective date of Plan, that is not less than amount that such holder would receive or retain if Debtor were liquidated under Chapter 7 of Bankruptcy Code

- Creditors must receive at least what they would get if Debtor were liquidated. Commonly known as "**best interests of creditors**" test - applies only to claims or interests that are impaired by, and have not voted in favor of, Plan
- Best interests test focuses on individual dissenting creditors rather than classes of claims or equity interests

10) Plan provides for full payment of certain administrative and priority claims on effective date of Plan

11) Unless Plan proposes for liquidation of assets of Debtor, confirmation of Plan is not likely to be followed by liquidation, or need for further financial reorganization of Debtor

12) Plan provides for payment of all fees payable under Section 1930 of the Bankruptcy Code on effective date of Plan (U.S. Trustee Fees), and for payment of retiree benefits, as that term is defined in Section 1114 of Bankruptcy Code

Section 1129 Requirements *(continued)*

Cooley LLP

13) Each class of claims or interests must either accept Plan or not be impaired by it

- If this provision can not be satisfied, Plan is confirmable pursuant to section 1129(b) of the Bankruptcy Code
  - Court may "cram down" Plan over its rejection by impaired classes of claims or equity interests as long as Plan does not "discriminate unfairly" and is "fair and equitable" with respect to such classes
    - Unfair Discrimination: The weight of judicial authority holds that Plan unfairly discriminates in violation of Section 1129(b) of Bankruptcy Code only if similar classes are treated differently without reasonable basis for disparate treatment
    - Absolute Priority Rule: Fair and equitable requires that holders of equity interests receive nothing on account of their interests under Plan unless creditors receive payment in full with interest.

Mechanisms by Which to Wind-Down a Liquidating Estate

Cooley LLP

- Post Confirmation Liquidation Vehicles ("**PCLVs**") allow Chapter 11 debtor to focus preconfirmation on more pressing needs of its reorganization or liquidation while deferring issues regarding illiquid estate assets, causes of action, and claims reconciliation until after Plan confirmation
- Many cases that do not use a more formal PCLV use a "postconfirmation estate" to fulfill similar role
  - Often either (a) a liquidating trust in all but name, or (b) loosely defined entity or reorganized or liquidating debtor fulfilling role of a PCLV in pursuing causes of action, recovering and liquidating remaining assets, and making distributions to creditors

PCLVs

Cooley LLP

- Chapter 11 Plans often provide for establishment of one or more PCLVs to collect and administer remaining assets of debtor's estate, distribute assets to various creditors, and, in some cases, pursue causes of action (including avoidance actions and other litigation) and claims of estate against third parties and former insiders of debtor

- Often, administration of the PCLV is subject to oversight of committee on behalf of beneficiaries of PCLV
  - Often includes, sometimes exclusively, members of former unsecured creditors' committee

PCLVs *(continued)*

Cooley LLP

- In smaller cases employing a PCLV, one PCLV is customarily established as residuary for all debtor's assets and causes of actions that are to be liquidated on behalf of creditors
- In more complex cases, a number of PCLVs may be established for specific functions
  - A "liquidating" trust liquidating miscellaneous remaining assets may be complemented by a "litigation" trust pursuing causes of action and, possibly, one or more additional trusts, each holding a specific type of assets

Relevance of PCLVs Is Increasing as More and More Chapter 11 Cases Liquidate

Cooley LLP

PCLVs have become more popular:

1) **Maximize value for creditors**
   - Use of a PCLV allows Plan to be confirmed, and distributions to begin, before all of debtor's assets have been liquidated or litigation completed, because often most complex and time-consuming matters are left for resolution by PCLVs
2) **Consistent with growing trend of Section 363 sales and liquidating Plans**
   - Trend toward Section 363 sales—involving all, or substantially all, of debtor's assets—and liquidating cases rather than stand-alone reorganizations

Relevance of PCLVs Is Increasing as More and More Chapter 11 Cases Liquidate
(continued)

Cooley LLP

3) Provide potential source of recovery to otherwise out-of-the-money creditors

- Beneficial interests in PCLV can
  i. be used as additional source of Plan currency, either to provide or supplement a claimant's recovery or
  ii. facilitate in sharing upside
- In event that proceeds of debtor's assets (or litigation recoveries) are high, even most junior creditors can share in recoveries

4) Reduce expenses of administering estate

- Consummation of Plan will reduce professional redundancy and often result in substantial savings, even after considering cost of PCLV and its professionals
- PCLV, if properly structured, can also change "adversarial environment" of Chapter 11 to become more cooperative

Relevance of PCLVs Is Increasing as More and More Chapter 11 Cases Liquidate
(continued)

Cooley LLP

5) Are attractive in post-*Enron/WorldCom* world of Sarbanes-Oxley where claims might exist against debtor's former insiders, accountants, financiers, and others

- In post-*Enron/WorldCom* world, and with enactment of Sarbanes-Oxley, litigation against debtor's former officers and directors and other insiders is likely to grow. Litigation is complicated, expensive, and time-consuming
- Issues can be resolved by transferring right to bring these actions (with unsecured and secured creditors even agreeing to share in recoveries) to PCLV

Different Forms of PCLVs

Cooley LLP

- Creditors have significant input regarding form that PCLV will take. Typically, PCLVs are either an entity taxed as a **grantor trust** or as **partnership**
- Term "grantor trust" is used in Internal Revenue Code to describe any trust over which grantor or other owner retains power to control or direct trust's income or assets
  - If trust is grantor trust, then grantor is treated as owner of assets, trust is disregarded as separate tax entity, and all income is taxed to grantor
- PCLV taking form of trust should generally be treated as grantor trust for tax purposes

Liquidating Trusts

Cooley LLP

- Most common form of PCLV
  - Liquidating trust "is organized for the primary purpose of liquidating and distributing the assets transferred to it, and its activities are all reasonably necessary to, and consistent with, the accomplishment of that purpose"
  - IRS has published guidelines regarding what constitutes a "liquidating trust"
- A liquidating trust can be either a "complex trust" or a "simple trust"
  - Complex trust - maintains income and expense at trust level and income tax consequences are paid at trust level
  - Simple trust - all income and expenses, along with associated tax consequences, are passed through to beneficiaries
- PCLVs taking the form of a liquidating trust are generally simple trusts

Liquidating Trusts *(continued)*

Cooley LLP

- There are other trust arrangements that are created for purpose of carrying on trade or business
  - Referred to as “business trusts” because they are created to continue business operation
  - Business trusts are treated as either corporations or partnerships for federal income tax purposes
- Governing document of liquidating trust must include statement that trust is organized primarily for purpose of liquidating assets transferred to it, with no objective to continue or engage in conduct of trade or business

Liquidating Trusts *(continued)*

Cooley LLP

- When PCLV takes form of liquidating trust that will be taxed as grantor trust, key issue is whether trust form will be respected

- As general matter, entity will be taxed as a trust if it can be shown that purpose of arrangement is to vest in trustee responsibility for protection and conservation of property for beneficiaries who cannot share in discharge of this responsibility and, therefore, are not associates in a joint enterprise for conduct of business for profit

  - If PCLV does not qualify as trust, whether due to excessive business activities or otherwise, entity will be taxed as business enterprise

Liquidating Trusts *(continued)*

Cooley LLP

- In Revenue Procedure 94-45, IRS established separate set of conditions that must be satisfied for trust established pursuant to a confirmed Plan to be classified as liquidating trust
  - A liquidating trust formed pursuant to a confirmed Chapter 11 Plan is "generally structured to satisfy, to the extent possible," guidance set forth in Revenue Procedure 94-45
  - In case of trust created outside of Chapter 11, private letter ruling request may be filed seeking liquidating trust classification for trust, if conditions of Revenue Procedure 82-58 are met

Liquidating Trusts *(continued)*

Cooley LLP

Key provisions of Revenue Procedure 94-45:

1) Trust is or will be created pursuant to confirmed Plan under Chapter 11 of Bankruptcy Code for primary purpose of liquidating assets transferred to it with no objective to continue or engage in conduct of trade or business
2) Plan and disclosure statement must explain how bankruptcy estate will treat transfer of its assets to trust for federal income tax purposes
   - Distribution to creditors of beneficial interests in liquidating trust (that is taxed as grantor trust) is generally treated as though following had occurred:
     a) debtor transferred assets earmarked for trust to creditors in satisfaction of their claims, and
     b) creditors contributed received assets to trust in exchange for beneficial interests in liquidating trust

Liquidating Trusts (continued)

3) Plan, disclosure statement, and any separate trust instrument must provide that beneficiaries of trust will be treated as grantors and deemed owners of trust
   - Trust instrument must require that trustee file returns for trust as grantor
4) Plan, disclosure statement, and any separate trust instrument must provide for consistent valuations of transferred property
5) All of trust's income must be treated as subject to tax on current basis

Liquidating Trusts (continued)

6) Trust instrument must contain a fixed or determinable termination date that is reasonable based on all facts and circumstances
   - Generally not more than **five years** from date of creation of trust
   - Term of trust may be extended for finite term based on particular facts and circumstances
   - Trust instrument must require that each extension be approved by court within six months of beginning of extended term
7) Trust not permitted to receive or retain cash or cash equivalents in excess of reasonable amount to meet claims and contingent liabilities (including disputed claims) or to maintain value of assets during liquidation

Liquidating Trusts (continued)

Cooley LLP

8) Trust must be required to distribute at least annually to beneficiaries its net income plus all net proceeds from sale of assets
   - Trust may retain an amount of net proceeds or net income reasonably necessary to maintain the value of its assets or to meet claims and contingent liabilities (including disputed claims)
9) It must be represented that trustee will make continuing efforts to dispose of trust assets, make timely distributions, and not unduly prolong duration of trust
   - If trust clearly meets all requirements contained in Revenue Procedure 94-45 without requiring an explanation, IRS is "unlikely to find grounds for attack" of trust's classification

Partnerships

Cooley LLP

- Postconfirmation partnerships, while likely impractical for larger bankruptcy cases, appear to be used with some frequency when unsecured creditor class is relatively small
- Partnerships, as compared to trusts, can be formed more easily and cheaply without attendant concerns over tax qualification
  - It is not difficult to ensure that IRS will respect choice of partnership form
  - Generally, any entity will be treated as partnership unless entity (a) attempts to classify itself as a trust, (b) is incorporated, and/or (c) elects to be taxable as corporation

Partnerships *(continued)*

Cooley LLP

- The form of transfer of interests in liquidating partnership to debtor's creditors is not important from federal income tax perspective
  - Debtor could transfer assets to its creditors in satisfaction of their claims with creditors transferring these same assets to newly-formed partnership in exchange for partnership interests, or, more commonly, debtor will transfer its assets to partnership and then transfer partnership interests to creditors
- Postconfirmation entity that is classified as partnership will have its income taxed to its partners on a flow-through basis
- Major advantage to using a partnership form over a liquidating trust is greater flexibility of partnership form, particularly as partnerships are not subject to any limitation on their business activities
- As practical matter, determination of whether to use liquidating trust or partnership often comes down to value that creditors place on ability to trade interests in PCLV

Limited Liability Companies

Cooley LLP

- Some commentators expect that LLCs will become increasingly popular as PCLVs because of greater flexibility of LLC vis-à-vis a liquidating trust, partnership, or corporation
  - An LLC has been used as a PCLV in at least a few cases:
    - *First Amended Joint Liquidating Plan of Reorganization of US Office Products Company and its Subsidiary Debtors*, at § 8.5, In re US Office Prods. Co., Case No. 01-646 (Bankr. D. Del. Nov. 5, 2001) (providing that an LLC will act as PCLV for debtors' assets and causes of action)
    - *Third Amended Joint Plan of Liquidation of (1) Borden Chemicals and Plastics Operating Limited Partnership and BCP Finance Corp. and (2) BCP Management, Inc.*, at Arts. V.B., V.C., In re Borden Chemicals and Plastics Operating Limited Partnership, Case No. 01-1268 (PJW) (Bankr. D. Del. Dec. 5, 2002)(providing that two LLCs will act as PCLVs for debtors' assets and causes of action)

Corporations

Cooley LLP

- Although use of corporate structure to collect and distribute assets postconfirmation is of dubious merit due to two-level tax faced by corporations and their shareholders, two reported cases have been found where a corporation was used. See
  - In re Consolidated Pioneer Mortg. Entities, 264 F.3d 803 (9th Cir. 2001)
  - In re AB Liquidating Corp., 416 F.3d 961 (9th Cir. 2005)
- Corporate form is probably most often used where postconfirmation administration is performed by reorganized debtor

Keys to a Successful PCLV

Cooley LLP

Key points to consider no matter form of PCLV used:

1) Naming and Retention of Wind-Down Officer

- PCLVs are typically governed by board of directors-like oversight committee, drawn from its beneficiaries or other constituents, and run on day-to-day basis by single individual usually called a liquidating trustee, plan administrator, responsible person, or wind-down officer (collectively, "**WDO**")
  - WDOs are generally either former member of debtor's management or professional WDO who specializes in wind-down or turnaround roles

Keys to a Successful PCLV *(continued)*

Cooley LLP

- Best practice: WDO should be retained pursuant to separate agreement that specifically sets forth terms of retention more specifically than summary terms contained in Plan
  - Retention agreement should be approved by Court, either as part of Plan or by separate motion or application
  - Typically, WDO is indemnified by assets of PCLV, but errors and omissions insurance as well as tail liability insurance policies are still necessary because once assets of PCLV are distributed, they are not available to protect WDO
- Retention agreement should be particularly clear regarding (a) replacement or removal of WDO; (b) scope of WDO's duties; (c) fee structure; and (d) mechanism for resolving fee disputes
  - Clear definition of liquidation trustee's duties also helps to minimize future fee disputes over duplicative duties and "turf battles" among parties with differing responsibilities under Plan

Keys to a Successful PCLV *(continued)*

Cooley LLP

- Generally, Plan will provide that professional fees do not need to be approved by Court to be paid. However, Court will generally be retained as forum to resolve any fee disputes, due to its experience with case, professionals and fee dispute issues
  - Oversight of professional fees is generally achieved by requiring notice (and providing opportunity to object) to certain parties in interest, such as oversight committee, reorganized debtor, and/ or other case constituents
- Proponents of Plan by which PCLV will be established must select wisely and be careful to include sufficient disclosure regarding identity and affiliations of proposed directors and officers (such as a WDO) for debtor, its affiliates (if any) participating in a joint Plan, and any successor to debtor (such as a PCLV)
  - Some cases have extended disclosure required under Section 1129(a)(5) to include individuals making up an oversight committee. See, e.g., In re Beyond.com Corp., 289 B.R. 138, 145 (Bankr. N.D. Cal. 2003)

Keys to a Successful PCLV *(continued)*

Cooley LLP

2) Oversight Committee or Board of Directors

- WDO should report to oversight committee that represents beneficiaries of PCLV

3) Retention of Professionals for a PCLV

- WDO must be invested with authority to retain counsel and other professionals as necessary to administer PCLV
- If practicable, PCLV's governance documents should provide that, absent conflict, WDO and oversight committee can be represented by same counsel and professionals
  - Minimizes administrative and logistical hassles and is generally appropriate because interests of WDO and beneficiaries of PCLV are generally aligned

Keys to a Successful PCLV *(continued)*

Cooley LLP

4) Access to, Retention of, and Incentivizing Employees of Debtor

- If debtor is to be dissolved, WDO must have ability to retain necessary employees to maximize value of PCLV
- WDO should also have authority, subject to authority of oversight committee, to install appropriate performance incentives for retained employees, generally tied to overall recoveries received by beneficiaries or another, more employee-specific metric

Keys to a Successful PCLV *(continued)*

Cooley LLP

5) Reporting Obligations and Communications with Constituencies

- PCLV's governing documents should set forth reporting obligations of WDO, both with respect to taxes and communications with oversight committee and beneficiaries of PCLV
- WDO's ability to communicate with beneficiaries can be increased while reducing costs of such communication through use of website

Keys to a Successful PCLV *(continued)*

Cooley LLP

6) Unclaimed Distributions

- Invariably, some distributions made by WDO will be returned as undeliverable or otherwise be unclaimed

  - Customary to include a provision that provides that distributions that have not been claimed within a certain period (often 90 to 180 days) after initial effort at making such distribution are forfeited to PCLV for benefit of other beneficiaries or may be donated to charity

Keys to a Successful PCLV *(continued)*

Cooley LLP

7) **Record Date for Distributions**

- Plan typically establishes "record date" that establishes date upon which indenture trustees and transfer agents will freeze their registers and that is last day that transfers of claims against debtor will be recognized
  - Record date should be established well in advance of occurrence of effective date under Plan so that claim holders know deadline for consummating any desired claims transfers and to ease administrative process of closing and recording any transfers of claims against debtor

8) **Funding, Budgeting, and Establishing Reserves for PCLV**

- Crucial that governing documents of PCLV ensure that sufficient funds will be available to administer PCLV properly
  - Administrative expenses generally consist largely, though not exclusively, of professional fees and expenses

Keys to a Successful PCLV *(continued)*

Cooley LLP

9) Arbitration Provision

- In light of courts' differing interpretations of postconfirmation jurisdiction (some courts require issue to have close nexus to Plan to retain jurisdiction), it may be advisable to include arbitration provision in Plan
  - Arbitration provision would give PCLV option to arbitrate claims and causes of action rather than litigating them in a court other than bankruptcy court
- Through res judicata and binding effect of confirmation, Plan provision allowing arbitration of claims and causes of action by PCLV is likely to be enforceable against all parties

Keys to a Successful PCLV *(continued)*

Cooley LLP

10) Definition of Allowed Claims

- In drafting Chapter 11 Plan, reserve PCLV's rights to object to claims during post-effective date claims reconciliation process
  - Plans typically set deadline for objecting to claims at approximately 180 days after effective date
  - Care should be taken in formulating the Plan's definition of terms "allowed claim" and "disputed claim" to provide clarity regarding which claims remain subject to objection

11) Distribution Dates

- Timing of distributions should be at discretion of WDO or oversight committee rather than require distributions on date certain

Keys to a Successful PCLV *(continued)*

Cooley LLP

12) Cash-Out Option for Beneficiaries of a PCLV

- Market for beneficial interests may be illiquid both before and after effective date
- Cash-out option for beneficiaries would likely reduce transaction costs and increase recovery for other interest holders

Keys to a Successful PCLV *(continued)*

Cooley LLP

13) Securities Exemption/ Trading of Interests in a PCLV

- Interests in PCLV may be considered "securities," particularly in light of broad definition of "securities" under federal securities laws
- To extent that PCLV may be deemed an "affiliate" of debtor, provide in Plan and PCLV documents that interests in PCLV are exempt from registration to extent provided in Section 1145 of Bankruptcy Code
- In at least some cases, Chapter 11 Plans have specifically prohibited transfers of PCLV interests that would cause PCLV to incur unfavorable tax consequences
  - See, e.g., *Order Confirming the First Amended Joint Liquidating Plan of Reorganization of US Office Products Company and its Subsidiary Debtors*, at ¶ 2(b), In re US Office Products Co., Case No. 01-646 (PJW) (Bankr. D. Del. Dec. 13, 2001) (modifying section 8.5 of the Plan to prohibit transfers of PCLV interests that would cause PCLV to become subject to the Exchange Act and/or the Investment Company Act)

Keys to a Successful PCLV *(continued)*

Cooley LLP

14) Multiple Classes of Beneficial Interestholders in PCLV

- It can be valuable to establish multiple classes of beneficial interestholders in PCLV
  - Can help to allow claimants that are expected to be out of money to receive recovery in event that recoveries by liquidating trust are larger than expected
  - It could even be enough to encourage them to support the Plan

15) Duration of a PCLV

- Governing documents for PCLV should provide for circumstances in which PCLV will terminate
  - One termination event is generally distribution of all of PCLV's assets

Keys to a Successful PCLV *(continued)*

Cooley LLP

16) Provisions Seeking to Ensure Appropriate Tax Treatment of a PCLV (If form is a Liquidation Trust)

- Structure and terms of liquidating trust can be used to make clear type of tax treatment contemplated in Plan negotiations and try to buttress such treatment by limiting WDO's ability to take actions that could be interpreted as inconsistent with desired tax treatment.
- Number of different types of provisions can help ensure appropriate tax treatment:
  - a) limitations on WDO's authority
  - b) guidance on tax reporting
  - c) limitations on investment powers
  - d) limitations on duration of PCLV

Powers of a PCLV and a WDO

Cooley LLP

1) **Discretion to Pursue, Settle, and Abandon Claims and Causes of Action**

- Powers of WDO are limited, but generally include power to:
  - sell certain PCLV property
  - pursue avoidance actions and other litigation to increase assets of PCLV
  - operate PCLV property (to extent necessary to maintain its value)
  - object to claims against debtor and settle such claims, including disputed claims
  - employ attorneys, accountants, and agents
  - make distributions to beneficiaries of liquidating trust pursuant to Plan

Powers of a PCLV and a WDO *(continued)*

Cooley LLP

2) Ability to Sell Assets of PCLV or to Incur Financing

- PCLV should provide WDO with power to sell PCLV property and incur necessary financing
  - These decisions may be subject to approval or review of oversight committee (at least if transaction is large enough) but generally not subject to Court approval after effective date
  - If Chapter 11 Plan is properly structured, sales of property transferred by debtor to PCLV for sale to third-parties may take advantage, pursuant to Section 1146(a) of the Bankruptcy Code, of exemption from transfers from "stamp tax or similar tax"

3) Ability to Invest PCLV Property

- WDO should be given authority to invest cash and other assets of PCLV to obtain market return on such assets pending distribution of such cash to beneficiaries

Retention of Claims and Causes of Action

Cooley LLP

- Chapter 11 Plan should provide for retention after confirmation and transfer to PCLV of any assets necessary to make up liquidating trust, including any claims or causes of action to be pursued

- In order to provide the PCLV with standing to pursue claims and causes of action transferred by debtor, Bankruptcy Code Section 1123(b)(3) presents three general requirements

Retention of Claims and Causes of Action
(continued)

Cooley LLP

1) Plan must retain claims to be asserted

- It is not clear how specifically Plan must describe claim or cause of action in order to retain that claim or cause of action for postconfirmation enforcement since courts have reached conflicting positions
  - At a minimum, Plan must "clearly evince the debtor's intent to reserve claims" and not just be a "mere blanket reservation" of rights
  - Plan provisions identifying claims and causes of action by type or category have been held not to be mere blanket reservations and, therefore, sufficient to satisfy standard under Section 1123(b)(3)
  - Other courts, however, have applied significantly stricter test requiring Plan to "specifically and unequivocally" describe each action to be retained

Retention of Claims and Causes of Action
(continued)

Cooley LLP

2) **If the person seeking to enforce the claim is a stranger to estate, person must be appointed and be a representative of estate**

   - A Plan authorized PCLV should have standing due to explicit authorization of Section 1123(b)(3) for postconfirmation estate representatives in conjunction with bankruptcy court's approval of Plan.

3) **Claims that are being reserved by plan for later enforcement and adjudication must belong to estate because plan may only preserve those claims that a trustee in bankruptcy, or a debtor in possession, could have asserted prior to confirmation**

   - Most courts have found broad definition of "claim" in Section 101(5) to include avoidance actions in context of Section 1123(b)(3)(B)

Retention of Claims and Causes of Action
(continued)

Cooley LLP

- PCLV should include terms preserving and transferring debtor's or Chapter 11 trustee's control over attorney-client privilege to liquidating trust along with causes of action and other assets