ABI Commission to Study the Reform of Chapter 11 Debates at the NCBJ Annual Meeting October 10, 2014

Mr. Togut: Good afternoon, I am Al Togut, Co-chair of the ABI Chapter 11 Reform Commission and seated right to my right is Bob Keach the other co-chair and we are very happy to see you all here. We are going to have an extremely interesting afternoon. This morning the Commissioners met again, in an effort to complete our work in time to issue a report in connection with the ABI Winter Leadership Conference this December. We've had a number of these meetings all over the country and we'll have some more before we finish our work. We have a terrific turnout of commissioners and I'd like to introduce who's here.

In the front table in the beautiful green suit is Deborah Williamson. Next to her past president of the ABI and the godfather of the commission, Cliff White the executive director of the United States Trustee Program, Steve Hedberg is to his left. At this end in the beautiful black outfit with the white pearls is Bettina Whyte. Next to her is Ken Klee. Immediately to my left is Jack Butler. Next is Michelle Harner our gifted and invaluable reporter without whom we just couldn't function. Next to her we have another past president of the ABI Jim Markus and at the far end in the gorgeous red tie is Don Bernstein. Bill Brandt has walked in. Hello Bill. Bob is going to introduce the format for today's debates and with that Bob it's all yours.

Mr. Keach: Thank you Al and thank you all for coming. Our format for today is essentially an oral argument. Think of the Commissioners here as the *en banc* panel. There will be argument by our speakers. The Commissioners as everybody knows, are not shy about asking questions and are permitted to do so. We'll try not to be too overbearing in that respect but I make no guarantees. We are going to have one slight change in the order of things. The second question will be the interest rate question and then the final question will be the *in pari delicto* defense question.

We are just trying to accommodate some travel schedules and I appreciate everybody being understanding about that. Without any further delay I want to introduce our first two advocates. Corinne Ball from Jones Day and Craig Goldblatt from Wilmer Hale in Washington. The question and I'll just read the question that is being argued here is, if a secured creditor asserts a claim against all of the value generated by sale of substantially all of the debtors assets or plan organization, should the court be able to set aside value from those transactions for the estate? The secondary question, should any such value be available only to pay administrative claims or also to general unsecured creditors? Advocates, we appreciate it.

Ms. Ball: Good Afternoon Commissioners. Thank you for inviting me to share my views with you. Obviously as we examine our approach to rescue and restructuring in the context of the 21st century cap structure, empirical evidence demands that we look at sales of substantially all assets outside of a plan. I believe that judges need a template, they need a statutory basis to address what is an increasing imbalance in the approach. Certainly when we have a plan, we have a template, 1129(a) tells us what we must do and 1129(b) tells us certainly what secured lenders are entitled to. That is the value of their collateral. When it's a sale outside of plan, unlike Chrysler of course and GM which had plans, it increasingly seems that there is little or no prospect for a plan.

We watch our judiciary falling into, retreating into the best alternative available and hope that it's less egregious. We have actually taken situations that 10 years ago, Judge Sigmund faced in Encore Health on bad facts and refused to permit a sale and did convert the case, to more recently last summer Judge Martin's experience on much better facts in Buffet Partners. The judges are doing an admirable job but they really don't have a template to deal with what is a widely shared perception: that chapter 11 creates a reorganization surplus, perhaps simply by virtue of its efficiency and having one forum for what could be a patch work quilt to state laws.

That surplus and its perception exists and when it is coupled with fiduciary duty of debtors [00:06:00] to maximize values for the collective stakeholders, the identical may not be known. At the beginning I think we are putting our judiciary in an impossible place without giving them an answer and a template as to how they should judge this and in fact handing them a matrix of first day orders which bias if not predetermine the outcome. We can take a very theoretical approach that one end of the spectrum we can say, on the first day we should quantify the value collateral so that we would know the exact measure of the surplus.

Even if that approach didn't fly in the face of some cases such as *Chataguay*, and *26 Trumball,* even if the extent of liens can be established and right now its certainly is not uniform with limited guidance whether it's Judge Krechefski, and whether it's a Ninth Circuit in *Kim*, there is far from a guiding light on the extent of a lien on going concern value. That valuation is impractical and that would be a fair comment but is the retreat to go to the other end of the spectrum and go to waiver, super priority claims and replacement liens? What's involved?

We have 506(c) waivers in very strict format advocated by the Second Circuit in *Flagstaff*. We have a more practical approach, modified in cases such as [inaudible] and *Hotel*. That really doesn't give our judges much leeway so now we are seeing waivers of 552(b) what are we trying to deal with? We are trying to deal with this perceived surplus and who should have a claim to it. That table is all too often set before you get to the sale of all the substantially all. I'm reminded of a nightmare of *West Point Stevens* whose super priority claims totally preempted and made a plan impossible.

We come to sale of all substantially all of the assets [00:08:00], staring at a dismissal as the best alternative available, with no assurance that the fundamental policies, of reorganization or rescue are met. In fact it seems to be a creeping appropriation, a lack of choice on the part of judiciary and data and needs to be addressed. There should be a statutory basis for judges to avoid falling into, if not creating a solution of the best remaining alternative. When the box and the tables are already set, the surcharge proposal is just such a proposal. There are three varieties that have been proposed and that is the second question. Which, should they be aimed at admin expenses?

We ask our judges to be amazing predictors of the future as we go through our first day orders. Whatever the process is, I think it must be flexible to assure that the surcharge will provide for at least administrative expenses if not more. I acknowledge that it will affect 364 loans. It will affect credit bids under 363 but we already know from *Fisker* and *Free Lance Star* that that is not an unlimited right, right now. We know it will affect the efficiency of the ubiquitous super priority claim that everyone gets as adequate protection on their first day. It all too often turns out to be a plan blocker if not a veto.

I for one, having witnessed almost 40 years of financial creativity, have total faith in our lending community that they will come up with solutions that will work together to meet the objectives of bankruptcy [00:10:00].

Mr. Klee: Counsel can the surcharge apply to post petition property only or can it apply against the lenders pre-petition property where DIP financers are the pre-petition lender?

Ms. Ball: Now without getting into whether, Professor Klee, we are talking about a defensive DIP or real new money, I think that the difficulty that 552 cases have presented it's very difficult. We talk about this surplus but it's very difficult to divine the extent to which it's actually proceeds of collateral. I'm reminded of the logic that Judge Glenn brought to *ResCap*. You may recall he said we have to look at 506(a) second sentence in combination with 506(c). If you get the waiver of 506(c) and services and other value dedication during the 11, create value, you got to pay for it. I would suggest say yes, if there is an increase in value and *ResCap* would be the clear case, it was all the lawyer services or so they told us, that totally improved the value of the collateral and facilitated those sales. In that case I think it is easy that was clearly a post petition contribution.

Mr. Klee: That burden should be on the debtor in possession to show that the increment in collateral was occasioned by the post petition activities?

Ms. Ball: I think the statutory proposal would be slightly different. I think we need a template that says since it is very difficult to divine, and it would vary from state to state, I would suspect. As to whether or not that incremental value was in fact proceeds or new property that we do need to meet the objective of the uniform proposal. Which will give the judges the ability, I think, to assess the surcharge and I would advocate on the value of all the debtors property or percentage of all the sales proceeds [00:12:00] perhaps if a plan were confirmed it becomes moot.

Mr. Klee: Ms. Ball, constitutionally how can we do that retroactively with respect to liens that we are in effect before the date of enactment of this proposal?

Ms. Ball: Constitutionally I think that we can do it as it is not clear that it is not post petition. It is not clear that these surpluses in many states as I said, there are roughly six decisions. Five of which suggest that it is proceeds, none of which say it is definitive as to whether or not it's really property interest within the protection of Fifth Amendment. I think that that differential among the states, given the bankruptcy clause and obviously the preemptive ability, that I think it could be done. I do not think it would be a retroactive taking in that context. It could only apply, professor, in the context of as sale where we have better empirical evidence it might be best to apply.

Mr. Keach: Counsel just looking at this issue in the sales context, it seems to me one you have this potential spread the increase in value from the sale process. It seems to me don't we also have the situation in the complex companies where a significant cost are avoided as compared to a state law foreclosure mechanism? For example, if you envisioned a 50 state company with assets in 50 states you'd have to do 50 foreclosures and 50 Article 9 transactions. At a baseline it strikes me that there is an avoided cost number that may …

Ms. Ball: I like to think of it as an efficiency surplus, Commissioner, that's due to chapter 11.

Mr. Keach: I'll take whatever label you want to put on it but that would suggest and this may also be a response to Commissioner Klee's Fifth Amendment question. Wouldn't the baseline be foreclosure value of the collateral and then we'd be measuring from there?

Ms. Ball: In fact I think that that was the theoretical premise but yeah with all that we asked our judiciary [00:14:00] to do on the first day, to ask them at that point establish foreclosure value on what could be 50 if not more jurisdictions, given our cross border nature. That becomes an overwhelming task and yes we are looking for rough justice to be achieved through a statute. I really do think it has to focus on a post petition activity as a consequence. The surplus that I would call the surplus that you defined, the efficiency of 11, lenders can choose by modifying the stay sometimes if there really is no equity to leave chapter 11. I think it has been the overwhelming experience that they choose to stay.

Mr. Butler: Counsel would we solve the same problem without getting into the surcharge in a black line surcharge rule, if we avoided the problem you talked about earlier which is the first day orders that predetermined outcomes. If there were changes made to the Code that prevented those kinds of orders from being entered, would that be sufficient?

Ms. Ball: It would be better. I suspect it would still not be sufficient if we are going to permit sales of all substantial assets under 363 outside of plan. Clearly the device that has many proven benefits, it has rescued many companies. If we are going to permit that I would suggest that we do, without knowing whether or not there can be a plan, I believe that a fail-safe with flexibility in the hands of the judiciary but at least in authorization point of a surcharge. That would come into place remain in place in the absence of their ever being a plan, would be the best balance.

Mr. Klee: Don't 506(c) and 552(b) do that? Wouldn't it be sufficient if we made them not waivable?

Ms. Ball: What would you do with the super priority [00:16:00] claim that has the same impact?

Mr. Klee: The super priority claim would only be available of there was a decline in the collateral; you're assuming that there is going to be a surplus?

Ms. Ball: From foreclosure value. Tell me when you value it? Do you recall that it was a 28 day trial in *ResCap* most of which was directed just to try to establish the value of the collateral on the petition day, more than one year later? It is incredibly difficult and the trials regarding whether it has been a diminution in value it happens so rarely and it's so expensive. Well theoretically I agree with you, I would suggest the expense might make it impractical.

Mr. Bernstein: Ms. Ball today most operating liabilities in large chapter 11 cases get paid, critical vendor orders and other things. You are really talking about the debt for borrowed money.

Ms. Ball: I wish that were true.

Mr. Bernstein: Would a rule of this kind have a result in changes in financing practices and subsidiariazation so that all of the debt for borrowed money would be at the holding company level. The senior creditors would be able to literally say yes I want a lifting of the stay, I'm just going to foreclose on the stock and sell it.

Ms. Ball: I would go back and say if I concurred in your observation that administrative expenses, not debt which I think of as having generally a greater priority than administrative expenses, were paid I don't think judges and we would be facing this issue with so much concern. I think it is the increasing experience that is not happening. We are witnessing structured dismissal and priorities among creditors on bad facts. The judges are facing optimizing a solution in a situation that's not as clear as you said. Yes, and to answer [00:18:00] your question I think we would see some adjustment, probably in pricing and cost, but it was really focused on the expenses of the process of chapter 11 and expenses incurred in 11, it should not be dramatic because that should already be happening. This is not a new concept. Your question embedded the answer that I'm looking for in seeking a statutory authority to make sure.

Mr. Bernstein: I'm sorry we are talking about two different kinds of surcharges, one with respect to administrative expenses but another was respect to unsecured creditors and I would distinguish those two.

Ms. Ball: I would I am concerned for the effective operation of rescue of secured capital that we must provide for administrative expenses. I think divining how one does that the practical way and I have great respect for many of our financial advisors in this space. The time and money that would be spent I'm just zeroing in exactly on admins it would be an estimate at best and I do think the judiciary needs flexibility. I think the question that I expected you to ask that I haven't gotten, and I thought maybe Mr. White would ask it is, is there a priority beyond admin that we should be worried about?

Because your surcharge question went directly to unsecured; I think we have another branch of the federal government Mr. White; that is also quite concerned about how we are handling sales substantially all outside of chapter 11. I would retreat and say no, it is the expenses to avoid the Constitution issue, it is the expenses incurred to preserve, protect and increase, almost like the statutory presumption of post petition operations.

Mr. Keach: Counsel on the sale point and this is probably the last point, you mentioned *Fisker* and *Free Lance Star*.

Mr. Keach: I think [00:20:00] particularly in the latter opinion there is a pretty clear expression of the fact that in a loan to own context that allowing unfettered credit bidding has the effect of standing the anti *Pinegate* provisions of the current code on their head. They are now not a shield to protect the secured creditor from all of the upside being taken from it, but rather not with sword by which the secured creditor usurps all of the upside value for its health to beginning of the case. If we accept that debate for a moment, how would you tie limitations on credit bidding to the payment of the surplus that you are advocating?

Ms. Ball: First I think our judges have done an admirable job in addressing the credit bidding issues with the flexibility provided for them for cause given the recent guidance from the Supreme Court. However I do think this proposal would affect credit bidding. It is saying that there must be cash proceeds, provided to meet the surcharge. It wouldn't care, credit bidding, but I always saw credit bidding as a remedy and not a Constitutionally protected property interest. This would not so impose or burden the remedy that it's intended to serve to protect their value.

Mr. Klee: In fact under *Radford* and under *Wright*, wasn't credit bidding one of the three defining characteristics of a secured creditors property right?

Ms. Ball: Yes it was. Yes they were but there are burdens that can impose on any exercise of remedy, professor from as minor as a filing fee, it's far greater.

Mr. Keach: Counsel, thank you can you take a minute to wrap up.

Ms. Ball: Of course thank you, thank you. I would like to say our objective, which is uniformity, a template for our judges to face the … to address the reality they face. The reality they face is everything is fairly unknown it shall ultimately come up. They may be [00:22:00] confronted with situations where there is no possibility of a plan. They need our help, they need statutory help and I would also submit that a surcharge of this nature might get us more plans and less structured dismissals, which I continue to believe as being incredibly jurisdictionally suspect. Thank you very much.

Mr. Keach: Thank you counsel. Mr. Goldblatt.

Mr. Goldblatt: Thank you, good afternoon and may it please the Commission.

Mr. Keach: Little pleases the Commission. [Laughter]

Mr. Goldblatt: The question as I understand it, is whether we would live in a better world if there were a surcharge that applied in the context of sales only, that in question one would require a surcharge on the collateral for the purpose of satisfying administrative claims. Secondarily a surcharge for the purpose of creating value that would be distributed to unsecured creditors. Let me suggest that in many respects the question, the first question understates the simple genius of the existing Bankruptcy Code. In that respect it is a solution in search of a problem and that the second solution is a bad idea as a matter of policy.

As to the first, the premise I take it is, secured creditor encourages a filing, the property is fully liened up and the likely value of the property is less than the amount of the secured loan. [00:24:00] There is no question that it's a blanket lien so substantially all of the debtors' assets are subject to the secured creditors lien. That it will sell for more in bankruptcy than the secured creditor would recover out of bankruptcy, so there is a going concern surplus or bankruptcy surplus here. That even after that surplus there is no money for anyone other than the secured creditor. If that's the situation we are addressing, it seems to me that under … this happens everyday.

Someone comes into bankruptcy court in that situation a bankruptcy judge looks at these facts and says, look you filed this case it is at risk of being administratively insolvent. If the case is administratively insolvent or appears to be administratively insolvent, a plan can't be confirmed. If a plan can't be confirmed the case should be dismissed so you secured creditor, you are not going to get the upside benefit of the reorganization without paying the cost of that. That principle itself is very hard to argue with.

Mr. Keach: Why not codify it then? If it so obvious that this is a good thing and it's in fact become quite uniform practice, then why not codify it? Because it seems to me that if you don't codify it, what you are saying is whether or not the secured party is sharing that avoided cost is up to the secured party. That seems to me to be antithetical to what you are saying.

Mr. Goldblatt: Well it certainly going to be the choice of the secured party who can decide to exercise remedies outside of bankruptcy to begin with. Once you are in bankruptcy I'm not aware of many bankruptcy judges who are going to allow the case to proceed without seeing to it [00:26:00] that the cost of proceeding is paid by the secured creditor. You don't end up in a situation which there are administrative costs that are run up that are unsatisfied, to the extent … to the extent the proposal is narrowly focused on addressing that point and creating some sense of uniformity and regularity and coherence around that principle, I'm not sure, not to break from my assigned role, I'm not sure that that narrow point is one with which we have … I have an enormous amount of disagreement. Of course the devil is in the details.

Mr. Keach: Okay that's progress, we can move to the next item.

Mr. Goldblatt: In concept I also don't … I think to the extent what the Commissioner is talking about in that regard is codifying what really is existing practice. I mean not actually a change in the substance of bankruptcy law, that's something to talk about.

Mr. Bernstein: Can I ask a question about that just to be the devil's advocate? A lot of those administrative costs are often incurred as a result of out the money classes trying to prolong cases. How do we address that problem in the context of a world where we are saying everybody's administrative expenses are going to be covered out of the collateral?

Mr. Goldblatt: Great. No look when I say the devil is in the details, that's one of the details. Surely it would be a mistake to create a world in which basically the secured creditor is forced to write a blank check to the terrorist committee that wants to engage in conduct when it's clearly out of the money.

Mr. Bernstein: Well I wouldn't even call it terrorism; it's just in their interest to try to extract a hold up value.

Mr. Goldblatt: That happens today. You could in the guise of a lien challenge or any other basis [00:28:00] deal with that problem. I do think in that regard what your … to address the particular detail in which the devil lies for a second. To the extent the administrative claim that is that issue is the interest of litigant and advancing its own interest, this surcharge shouldn't be a substitute for the American rule. In which litigants bear their own cost of advancing their interests.

Mr. Klee: All right so which administrative claims are you going to pay? You are going to pay the post petition wages?

Mr. Goldblatt: Post petition wages.

Mr. Klee: The post petition severance to the WARN Act liabilities? The capital gains on the sale of assets, tort claims all of those …

Mr. Goldblatt: Post petition torts.

Mr. Klee: Post petition torts absolutely right.

Mr. Goldblatt: *Redding* situation.

Mr. Klee: Right all of that is going to be covered.

Mr. Goldblatt: That sounds like the cost of trying to reorganize the business and to the extent the secured creditor wants the upside involved in reorganizing the business it is fair.

Mr. Klee: Pay to play.

Mr. Goldblatt: Yes in that respect.

Mr. Klee: I thought that was Ms. Ball's side of this debate? [Laughter]

Mr. Markus: How do you reconcile the fact that in the Code there is one class of administrative claims but yet in the lender's eye, the pre-petition deliverables of goods that you could foreclose on, you don't want to pay those post petition but yet the judge has to face the reality that administrative priority is the exact same as the post petition wage claimant. That really is the rub because that's where I've seen the administrative liability where you have out of the box administrative insolvency cases, that the lender doesn't want to fund.

Mr. Goldblatt: Right. Let's make sure we are talking about the same vocabulary. Question one is what does the Bankruptcy Code now define as an administrative claim or administrative expense? The question that I think is fairly addressed is [00:30:00] what are in fact the costs of getting from the petition date to the reorganization date. I guess where I'm willing to bite off in this conversation is to the extent what you are talking about is the actual cost of getting from the petition to the reorganization. Where the reorganization is all to the benefit of the secured creditor, it is not unreasonable to say that the administrative … that the secured creditors should not be able to free ride on the efforts of others.

Mr. Keach: Mr. Goldblatt let me just to shift gears for a second to ratched up to the next question. I'll ask you somewhat the same question I asked Ms. Ball that is one of the ways of looking at this problem is that you have … you as the secured party have a bundle of state law rights. The enforcement of which is not nearly as efficient in transferring value to you as the Bankruptcy Code. In other words whatever you want to call it: either an efficiency premium, an avoided cost, whatever you want to call it there is an identifiable spread. That spread is obviously greater the more complex the case is and the more geographically diverse, it might be actually nonexistent in the simplest single asset case.

Why shouldn't we be trying to have this surcharge, as opposed to trying to look at what we pay with it? Why shouldn't we be trying to measure this as the sharing of that spread?

Mr. Goldblatt: That's the question I thought I was addressing and where I disagree with the suggestion that this makes sense.

Mr. Keach: That's why I was redirecting you back to it, you are welcome.

Mr. Goldblatt: Thank you commissioner.

Mr. Togut: It's a hot bench.

Mr. Goldblatt: Now to return at some level to first principles it seems to me that one of the great genius points of American bankruptcy law has been that [00:32:00] it sees as its purpose maximization of value. That beyond maximizing value as to the distribution of value, it essentially takes parties non-bankruptcy rights as they are and distributes the value in accordance with their non-bankruptcy rights. That principle is sometimes described as the *Butner* principle, although Commissioner Keach will tell me I've completely misunderstood that opinion. Has nothing to do with that proposition.

Mr. Keach: You just totally oversimplified to the point of irrelevance but go ahead.

Mr. Goldblatt: With respect to that principle, the simple idea that we seem to maximize the value but we are otherwise with a handful of exceptions, all of which are probably bad ideas, agnostic as to the distribution of that value and we leave people state law rights more or less as they are.

Mr. Keach: Well let me just put it in a *Butner* manner not as to be a total dialogue. To put it in a *Butner* framework, *Butner* says you recognize state law rights unless there is a compelling federal interest that would dictate a different result.

Mr. Goldblatt: To be sure.

Mr. Keach: When would you find such a compelling federal interest to exist?

Mr. Goldblatt: Well let me say what I think is not such a such a compelling federal interest, which is redistribution of value for its own sake or an effort to solve in bankruptcy a problem that is really a non-bankruptcy problem. Whenever you do that, when you create distortive distributional effects in bankruptcy that lead to materially different winners and losers in bankruptcy than you find out of bankruptcy. You create a host of problems that would lead to the risk of essentially either forum shopping into bankruptcy or out of bankruptcy by people who would like to be the winner or the loser.

That's the point that in the late '90s during the reforms to the UCC, [00:34:00] then-Professor Warren I think correctly expressed when she said look, if you want to carve out from the collateral, it only makes sense to do it as a matter of non-bankruptcy law. Because if you want to change people's distributional rights, let's be candid about what we are doing, and saying we are going to redistribute their rights. We are going to take away what it means to hold a lien and just do that. As opposed to creating a different effect in bankruptcy than out because then you end up with a rash of involuntary petitions by those who, out of bankruptcy face nothing, but in bankruptcy have the chance to be the beneficiary of this Commission's surcharge.

Mr. Klee: That proves way too much and can't possibly be right. Under the Supremacy Clause the Bankruptcy Clause is going to trump the state law rights. If you leave it to 50 state legislators to determine what a collateral package is, some states could give liens on kidneys, the debtor's first born. The Bankruptcy Clause as a matter of policy could find that that's reprehensible and that is a matter of equality or fresh start, we are not going to recognize that bankruptcy. As long as that's applied prospectively sir, there is no problem with people knowing what their rights are. It's always subject to the Bankruptcy Clause, which is part of every contract under non-bankruptcy law.

Mr. Goldblatt: Professor Klee, maybe I wasn't clear, let me try that again. I wasn't suggesting that there was a onstitutional issue. I was addressing the question does this idea make sense and I suggest it doesn't. As to whether the Bankruptcy Clause would permit a world in which the Bankruptcy Code chose winners and losers and people forum shopped into bankruptcy in order to be such a winner as opposed to a loser. Sure the Constitution probably would permit that. My submission is that that would not be a better world than the one which we live which bankruptcy law is generally ambivalent or agnostic as to who the winner or loser is. Basically these peoples state law rights are in place [00:36:00].

Mr. Bernstein: Let me probe that for a second. One of the questions that can be legitimately be asked is when you change the remedy to a collective remedy that eliminates the risks of foreclosure and preserves the full value of the enterprise as of a particular day. The question about what happens in the future and changes in value of company over time becomes very relevant. There were a number of companies that filed for bankruptcy in 2008 and were considered woefully administratively insolvent at that point. Many of them, when they emerged from bankruptcy years later, it turned out that their market capitalization and value exceeded what would have been a secured debt in the bankruptcy case.

The question is because bankruptcy cuts off huge responsibilities but it does preserve upside, whether that is a good or a bad outcome? Whether if we are going to preserve upside for the secured creditor that doesn't lead to whole different set of results, from the situation where yes you have your state law rights to foreclosure but this is a whole different scheme.

Mr. Goldblatt: Sure, but apologize for seeking clarification, okay so a company comes in you think it's under water when it comes in. it turns out that the business cycle turns and now there is added value. Now the people we thought were out of the money are in the money.

Mr. Bernstein: Right and what happens though if, before that business cycle turns the plan of reorganization has been proposed that wipes out the junior class? The court values the company on that day and cuts off all future possibilities.

Mr. Goldblatt: Right and so and that's a variant of a question that arises in every bankruptcy case all the time which is, is management exercising prudent business judgment putting forward this plan? Or does it make more sense to wait until [00:38:00] there is a better plan that comes down the road?

Mr. Bernstein: This management only has.

Mr. Goldblatt: Excuse me.

Mr. Bernstein: Go ahead.

Mr. Butler: Are we talking about the case where there is a DIP where it requires a plan be filed by a milestone or one where there is not? Who's in control: the management team or the lenders?

Mr. Goldblatt: Well unless you mean that the management team got the best DIP they could find.

Mr. Berman: That doesn't solve the problem.

Mr. Butler: I don't think that was responsive to the question.

Mr. Goldblatt: It was, look the issues around the DIP market are a set of questions that one can talk about to be sure is it my experience that management waits too late and by the time it comes to find a DIP it ends up having no choice, yes.

Mr. Butler: Just to explore that for a moment. If your premise is, is I think you called it the brilliance of a current system is that it has all these provisions in it that allow it to function. Should the commission be focused on trying to make sure that those provisions are in fact available to the debtor in possession? Not capable of being negotiated away so that there is some checks and balances on in balances of power?

Mr. Goldblatt: Yes so Commissioner Butler that's a fair and good question. The Code operates on the assumption that the management of a debtor operates in fiduciary capacity and that there is a market at work. That the DIP loan will be by management under the best term management can find. That they are acting in a fiduciary role and they agree to those terms to the extent that there are terms that … and again I'm not here saying that every DIP loan I've ever seen is ideal for a maximization from value perspective. The notion that there might be particular provisions [00:40:00] that undermines the value maximization is a question that can be discussed those are fair questions.

Fundamentally on the distributional question, once you maximize value it does seem to me that that the Bankruptcy Code, properly understood, shouldn't express a distributional preference beyond what state law otherwise provides.

Mr. Keach: Mr. Goldblatt let me …

Mr. Goldblatt: [Inaudible 00:40:31].

Mr. Keach: Mr. Goldblatt let me ask one question and maybe a follow up and then I'll ask you to wrap up. You would agree would you not in the case where we are selling substantially all the assets for going concern value that at least some aspect of that going concern value is the product of the preposition investment of employees and unsecured creditors and other stakeholders in the state, would you not? There would appear to be an unavoidable yes right?

Mr. Goldblatt: Yes.

Mr. Keach: Thank you stop there for a second, [laughter]. If that's the case why should we allow through a sales system for the secured creditor to capture all of that value?

Mr. Goldblatt: Commissioner Keach, to the extent it is the case that what you said is true that there is value, what a secured creditor is entitled to today under the code under section 506(a) is the value of their lien. As the language is written it's the creditor's interest in the estates interest in the property.

Mr. Keach: On a liquidation value basis?

Mr. Goldblatt: No in light of the use to which the property is proposed to be put, I think is the language the very artfully written language that someone in 1978 crafted.

Mr. Klee: When it's sold it's a liquidation value basis?

Mr. Keach: You can be sure he's going to blame that on Levin. [00:42:00] I'm going to ask you to actually take minute and wrap up you can either take a minute to answer his question or I'll even give you the unfettered ability to just wrap up on your own because we've interrupted you a lot.

Mr. Goldblatt: Well I'm here to be helpful to the Commission and so I would welcome interruptions. The point that I haven't made which just in … so I do believe and think it clear that the Bankruptcy Code is operated quite well in a world where it is distributionally agnostic as to value in respect of state law rights. The point that I haven't made will involve the one about the market consequences to imposing a tax. That there is certainly a question of, from the bankruptcy perspective or all bankruptcy professionals, there is an element of if my only tool is a hammer every problem looks like a nail.

We believe that if there is a problem, which I believe is overstated, but if one believes there is a problem in the bankruptcy system one has to be careful that they don't solve that problem in a way that creates downstream effects. For all the companies that stay out of bankruptcy because of the ready availability of secured credit. Obviously a change that would materially alter the recoveries given default will have effects far out of the bankruptcy system. Where it much may well be true that the cure we devise is substantially worse than the disease.

Mr. Keach: Thank you [inaudible 00:43:41].

Mr. Goldblatt: Thank you.

Mr. Togut: Before you sit down I just want to thank you. You think we are abusing you but we are not. You've been at several of our field hearings and we have very much appreciated your participation and your insights.

Mr. Goldblatt: Well we appreciate the opportunity thank you.

Mr. Keach: Thank you.

Mr. Keach: I would only conclude by saying if you are going to build something you have to hammer a few nails. [00:44:00] All right thanks very much so we move on to our next question which is the interest rate question. Our advocates there are I'm going to butcher your name I apologize, Mr. Joseph Wielebinski thank you. Of Munsch, Hardt Kopf and Harr in Dallas and his opponent is Mr. Robin E. Phelan of Haynes and Boone, Mr. Phelan thanks. The question here is should the interest rate applicable to claims and a section 1129(b) cram down be determined under the formula adopted by the Supreme Court in *Till*, or are there alternatives that might work as well or better in a chapter 11 case, sir?

Mr. Wielebinski: Co-chairman, distinguished members ladies and gentlemen my name is Joe Wielebinski. The question that's raised is should the interest rate applicable to claims in the section 1129(b) cram-down be determined under the formula approach adopted in *Till* and then are there alternatives. The answer to the first question is really an unequivocal yes. With respect to the second question about alternatives, I think most of the alternatives that one might think about, particularly a secured lender might think about, have already been raised, presented and argued and considered and rejected, by the vast majority of the courts.

Now of course there can be other alternatives I don't know exactly what the Commission might be looking at, but in my humble view the only alternative or the only option that makes sense is that it be an amendment to the Code that simply contains a ratification of what *Till* directs. That is the formula approach at a risk free rate plus a risk adjustment of 1 % to 3% generally. I don't know of any basis that would justify anything other than that.

Mr. Klee: We'll adopt that for all trucks in chapter 11 is that the notion?

Mr. Wielebinski: I think we are [00:46:00] talking about the chapter 11 cram-down for trucks it may be different.

Mr. Klee: No trucks are what *Till* was about. The question is, is it different for everything else like accounts receivable and inventory and going concern businesses?

Mr. Wielebinski: I think the *Till* approach can apply against all of that collateral.

Mr. Bernstein: Let me just try to ask a question to clarify this issue, let's assume you've got a bunch of unsecured bond holders. The debtor wants to get value to the equity and the debtor proposes to pay the unsecured bond holders in cash 90 cents on the dollar. Can any money be paid to the equity if the bond holders vote against the plan?

Mr. Wielebinski: The answer is no.

Mr. Bernstein: Okay. Let's assume instead they propose to give a security with the face amount of 100 but that's worth 90 in the market, are you saying that just because the interest rate on that security satisfies the *Till* requirements that equity should be able to participate in the case?

Mr. Wielebinski: Yes.

Mr. Bernstein: All right and it wasn't their bargain to actually pay 100 cents on the dollar to the same creditor?

Mr. Wielebinski: If they couldn't negotiate throughout the entire process, both the debtor and the secured creditor, to reach a reasonable resolution that solves their problem, then the beauty of the cram-down rate is that they suffer the consequence if the judge finds that that's what indeed is what the Code requires.

Mr. Bernstein: What would happen if you were trying to use equity to pay the unsecured creditor? How would you value that, would that have to be worth 100 cents on the dollar in order to cram-down the unsecured creditor?

Mr. Wielebinski: In order to pay equity?

Mr. Bernstein: Yes to leave a residual for equity.

Mr. Wielebinski: I think the answer would be yes to that.

Mr. Bernstein: So. The only time that the unsecured creditor [00:48:00] is entitled … can be cram-down with less than 100 cents on the dollar is when they are getting debt paper with a *Till* interest rate. Because if they were getting cash they would have to get 100 cents if they were getting equity they would have to get 100 cents. If they get a debt piece of paper it can have a *Till* interest rate and they can get paid less than 100 cents.

Mr. Wielebinski: I believe that's correct.

Mr. Klee: Nonsense. That can't be your position. You are on the side of the case for *Till*. What the court does when it adopts the *Till* interest rate is its finding conclusively as a matter of law, that the appropriate discount rate to get to 100 cents is the *Till* rate. You can't be expected to take this security you are getting and determine and sell it on the market. That's never been the bankruptcy test, whether it's the equity you get or whether it's the note you get. Now cash you should be able to sell that in the market place for what you get. The bankruptcy judges finding is that the *Till* rate is the appropriate discount rate. Why shouldn't the standard here just be present value, why do we need to go to *Till*?

Mr. Wielebinski: I think there are a few reasons, one is that the statute does not require it. Two there is no obligation and Congress hasn't felt that there is an obligation to use the term market rate. Or payment in full, or a rate that would equal what you would receive if you were able to foreclose or enforce a new loan. Instead Congress simply said it is a discount to a stream of payments that are paid over time, bought back to a present value of today, that's all that's required. If I meet the *Till* requirements and I'm in cram-down, if the court approves that I've satisfied the requirement.

Mr. Klee: Commissioner Bernstein has made the point that the market is what determines the appropriate discount rate and *Till* is just some judges formulae off the wall [00:50:00] free rate plus 150 to 300 basis points. If the market for this particular debtor looking at the length of term of the note the collateral, the conveyance, the debtors credit worthiness the over levered nature of the debtor is such that you need to have 500 basis points spread. Then why isn't Commissioner Bernstein right, why isn't *Till* the wrong standard under the present value test that you just articulated?

Mr. Wielebinski: What Congress says is you use a discount rate to value that stream of payments. It does not say the magic words that you used, which was a market rate. It doesn't require that and if it wanted to, Congress could have put it in. Congress has put that rate into other provisions of the Code. It has also put in language in 506 that says, attorneys fees, cost and the contract rate. Congress knew that it could put those numbers it didn't do it. All *Till* did was because of Congress not coming up with the specific rate, just saying there is a discount that you use. *Till*, *Valenti*, *Grand Prairie,* all they did was simply put in a mechanism that the courts could use to try to find the appropriate rate.

I mean the appropriate number and it did it in a way that it gave the bankruptcy court a pretty broad amount of discretion to make that determination.

Mr. Butler: Counsel, let's not if we can, use as part of the argument what Congress said in the current statute. What we are trying to do here is figure out whether there is a better way, whether there are things we should recommend to Congress. Let's put aside for a moment how you interpret what Congress said or didn't say what magic words were there or not. Instead, I'd like your insight as to why *Till* is the right answer? If we could go to Congress [00:52:00] and Congress would adopt our recommendation, why should we tell Congress *Till* is the right answer?

Mr. Wielebinski: There are several reasons and I understand your clarification. I appreciate that. First of all, I think that this process and I've been involved for as long as you all have been, this process is a give and take. There is leverage on each side; one thing that I found from being lead counsel in the *Grand Prairie* case is, the cram down provision, if you just change it to market rate, there is absolutely no incentive for a lender to negotiate with you. They'll simple sit there and go look, I'm going to try to get the stay lifted I'm going to try to defeat your plan. Eventually the worst I get is what I get in the market anyway so how am I harmed?

Till works and it works only after you go through all the process of negotiating and trying to come up with something. In *Grand Prairie* the classic example was there. My client had great collateral, it had wonderful management, it had a good location. What it didn't have was a maturity that went any further and what happened in the meantime was the market collapsed. We had the bank crisis, and because of that we went to the lender and said let's negotiate something. What the lender came back with and said at that time, and I could understand it, we don't want a seven year note, we want our cash, we want to sell these things.

If they sold them it was the absolute worst time to sell those hotels, because the hotels lead the economy when it's taking off and lead the economy when it's going down. No one was going to buy those hotels and the only choice I had when the lender repeatedly came back and said, we are not going to negotiate with you. We are not going to respond to your offers, was to say I've got a cram down and I'll take you to the court. The other beauty of that standard the formula is that [00:54:00] before I filed the case, I could go to my client and say, here is the prime rate, one to three points. I can't tell you exactly where we are going to have to figure it out, but that's where we are going to end up if we are going to have to cram this down.

If we do a market rate and in the *Grand Prairie* case it came out at 10% was offered, a little under 10%. We came up with five they came up with 10 a magnitude you know they doubled the number. I couldn't have told my client what that number was until I either got the expert report, or I took the deposition of the expert and figured out how to calculate it. All of the factors that go into what a new loan would be.

Mr. Keach: Counsel just to pick up on that and then I'm going to ask you to wrap up in a second. Wouldn't you have the same leverage if we simply made it clear that what we were after here was present value? As opposed to and I appreciate the predictability of *Till* from the standpoint of advising clients. It seems to me it's based on a false premise and that is that there is a risk free rate. If we move away from that idea, wouldn't we get the same leverage for you if we simply clarified that present value had to be determined and had to be delivered? It seems to me that would raise the same level of uncertainty would also let you have a lower rate when the environment produced a lower rate. It wouldn't walk us into assuming that there is a risk free rate that never moves.

Mr. Wielebinski: I'm not sure I understand the entire proposal but the risk free rate is the starting rate. There are adjustments made to it so I want to make sure that we are both on the same wavelength on that. While I think you could look at something like that the problem I would have is that, we'd have to come up with language and we have to look at the devil in the details and see [00:56:00] if it really worked. It really adopted what the *Till* and it's progeny have directed. Number two is, then you have to take it to Congress who will go through the same process. Have the risks of lobbyists and special interests come in and look at it and I'm very concerned about that.

I'm concerned about it because it has clearly happened in the past and I can point to 363 and those changes; 365 almost any provision …

Mr. Berman: Sir that's not the charge of this Commission, the charge of this Commission was to look at the Bankruptcy Code and to propose reforms. It was not to look at the code propose reforms and then throw them out because it might not get through Congress.

Mr. Wielebinski: I understand but it may go to the point of, do we think that there are alternatives that need to be suggested? I think you could live with the current case law right now because the vast majority of the cases are adopting the *Till* approach, the formula approach. In fact the American Bankruptcy Law Journal came out and said the default rate for interest calculations under, or I'm sorry, for the discount rate under 1129 is the *Till* forumla.

Mr. Keach: Counsel can you take 30 seconds and wrap up.

Mr. Wielebinski: Okay. I didn't get to go through all the reasons but I would point out that I believe *Till* applies with the statute and the legislative history supports what the code has directed in *Till*. Because it says a discount rate, it doesn't say a market rate. It's straightforward, it's objective, it's uniform and it's consistent and that was a big issue for all of the courts. I know it's a big issue for the bankruptcy judges. In the Eastern District of New York just to try to determine whether there was an efficient market that took 11 days of trial [00:58:00] to determine there wasn't an efficient market that's ridiculous.

It shouldn't take that. It should instead say, bankruptcy judges do certain things well and they should look at the plan, the feasibility of the plan and how to look at a future stream of payments and bring those payments, back to a present value using an appropriate discount rate.

Mr. Keach: I'm going to have to cut you off there but thank you very much.

Mr. Wielebinski: Thank you.

Mr. Bernstein: Thanks. Mr. Phelan what hat do you have there?

Mr. Phelan: You'll find out.

Mr. Keach: This is completely a hat free zone.

Mr. Phelan: Now you tell me. Before I get into this discussion there is a politically incorrect old saying that solves the problem of the prior discussion on surcharge: "no ticky no washy." With respect to 1129, the courts are all wrong, from the Supreme Court on down. Section 1129 says the secured creditor is to receive deferred cash payments, with the present value equal to the value of the collateral. Deferred cash payments, doesn't have to be note. It could be a string of income from a lease, it could be anything. That seems simple enough but the courts have totally ignored the statute, and created an Alice in Wonderland construction, that defies reality to the point where the Fifth Circuit in the *Texas Grand Prairie* case mentioned by Mr. Wielebinski admitted that market reality had been thrown out the window.

Mr. Togut: Mr. Phelan take that thing off we can't [inaudible 00:59:51].

Mr. Phelan: The statute says that if my collateral is a gold bar [01:00:00] worth $1 million, then I'm entitled to a stream of payments with a value today of $1 million. That's what value is. The dictionary defines value as the monetary worth of something, it's also used in 506(a). 506(b) that Mr. Wielebinski said talked about is not relevant. That means what the market will pay on a given day under a given set of circumstances. The old willing buyer and willing seller concept.

Mr. Klee: If we have 2008, where the market has crushed and there is no buyer and no seller then the value is zero and the debtor can cram down to plan by giving the secured party nothing?

Mr. Phelan: There is always a buyer and a seller what's a …

Mr. Klee: No there wasn't in 2008.

Ms. Whyte: Mr. Phelan there certainly wasn't in Odessa and Midland Texas where we first met in 1985 either.

Mr. Phelan: It may not be a price that you want but there is always a buyer and a seller.

Mr. Keach: Mr. Phelan [inaudible 01:01:02] I mean frankly I think recent history has proven that that to be not true I can introduce you to a whole lot of holders of mortgage back securities from 2008 who couldn't sell for any price.

Mr. Phelan: I don't know about that, I don't know about that. It just depends on what's the price you want.

Mr. Klee: Live by the market die by the market Mr. Phelan.

Mr. Phelan: Exactly. A Picasso is worth what a Picasso is worth by definition. Evaluation of deferred payments requires a market rate of return or nobody will pay for full value. If my gold bar is worth $1 million then the deferred payment should give me have to be worth $1 million. That's an evidentiary question what rate of return is required for someone to give me $1 million for those deferred payments? Notice I didn't say interest.

Mr. Keach: Mr. Phelan, Counsel let me just ask you a question. One of the things we are trying to do is actually create [01:02:00] a new Code that has efficiency and lower cost. If *Till* or a formula like *Till* is as at least a reasonable proxy for what we are trying to accomplish, why should we promote a system where one had to put on expensive evidence with expensive experts and time consuming hearings to get to approximately the same place? Isn't it just more efficient to have something that predictable like the *Till* formula?

Mr. Phelan: Otherwise, you just pull out a number out of the air which is what *Till* did, it's not reality, it's just not reality. The current statute doesn't say interest it says value and there is always a market for deferred payments I think notwithstanding what you said. Maybe it's a systemic break down. It may be Luigi the loan shark or the Goldman Sachs debt trader and the rate of return may be higher than the debtor would like. There is always a way to value extremely deferred payments. I'm looking to actually buy a small shopping center. The valuation, the cap rate we are going to put on that is dictated by the differed payments we are going to receive from the stream.

That's what determines the value, what we are going to pay for. Just because the debtor calls part of the payments interest, doesn't mean it's interest. It's really a rate of return. Rate of return isn't a legal principle. That's one of the places where the courts have gotten totally off rails. They've mixed up starting with *Till* and the cases before *Till*, the concept of adequate protection with value and what the statute says in 1129. This isn't to put the secured creditor in some place where he otherwise would have been. It's to give a value to the price on that stream of payments. If the market rate of return to get the stream of payments $1 million on my gold bar.

It's to give the $1 million of value on a given day. If that's determined by what [01:04:00] Vladimir Putin says about the Ukraine or whether the Greeks fail on a bond or what Janet Yellen tells CNN then that's what determines value.

Mr. Butler: Mr. Phelan I've got to stop you there.

Mr. Phelan: Okay.

Mr. Butler: We are here to figure out what we should recommend the Congress and if I take everything you just said as being absolutely true, why would we ever recommend that approach to Congress? Which seems to be the most litigious, most expensive, most volatile approach we can possibly take to the 1129 issue. If I have to pick between that, and the till approach which is a formula, why wouldn't I going back to what Chairman Keach said why wouldn't I go for predictability in the system and pick the formulaic approach?

Mr. Phelan: Because it's not reality, it's just not, there you can pick, you can make anything the law, you can make anything the law you want it doesn't necessarily make sense though. [crosstalk 01:05:02].

Mr. Butler: From a policy perspective just help us what policy argument.

Mr. Klee: Mr. Phelan drop your gold bar and go to the real world, go to reality where we have businesses and we don't know what the value is we don't have a gold standard. Do we look at the reorganization value or the going concern value or the collateral or do we look at the liquidation value? This is important … No it's important to determine what the present value has to equal because you are telling me I've got to provide you with a stream that's equal to the value of your collateral. You got to answer this question for us now where you have a gold bar and there is a gold standard, it's easy. What about where there is a business and it's a business that if the debtor's operating it is worth a little more than it's worth if you are taking it and foreclosing on it. Because this was important to Justice Thomas. This was why Justice Thomas wrote his concurrence in *Till* and said look, we already answered this in *Rash* [01:06:00] as was previously pointed out, that the secured creditor is going to get the value of the business in place if that's what the debtor wants to do with it. Justice Thomas said it would be double counting to then give the secured creditor both the high end of the value and a market interest rate.

Mr. Bernstein: Can I, may I differ with Commissioner Klee because I think we are mixing apples and oranges here. Let's assume we are trying to pay the value of the allowed amount of the claim to an unsecured creditor. It's a much more straightforward *Till* question because then the question is how do you calculate value. Then we can compound that with the question of do you use going concern or liquidation value where the creditor is secured in determining the secured claim. *Till* could equally well apply to the calculation of the value what you are giving to an unsecured creditor on the unsecured creditors claim.

Mr. Phelan: If the statute was so …

Mr. Bernstein: Well if you are going to apply the absolute priority rule you have to determine whether the unsecured creditor has been paid in full.

Mr. Phelan: That's correct.

Mr. Bernstein: You are talking about the value of the allowed amount of the unsecured creditors claim and if they are given a debt instrument or they are given a stream of payments how do you calculate that.

Mr. Phelan: Yeah same way. I want to take the sequencing the other way around because honestly I do think Professor Klee had the sequencing backwards. 506(a) determines value and the cases are pretty plain it's got to be market value. When you are talking about your business your shopping center whatever it might be, that gets determined in 506(a). Whatever it is, it is courts make those determinations, rightly or wrongly I've been on both ends are of that one. Once you get that value then you apply 1129(b) and you are substituting for that thing something else a stream of payments. A stream of payments has a value and value means what I can sell it for.

In determining what I can sell it for [01:08:00] you have to apply what market rate of return is required to achieve that value. That's what reality is.

Mr. Bernstein: Would you take that though to the extreme of saying that even if the market is dysfunctional at that time you used the then current market rate. Or would you use some hypothetical market rate when markets normalize and … so the real question is how far do you carry that principle?

Mr. Phelan: Well a dysfunctional market is the market on a given day. This is a capitalistic society sometimes you have functional markets some dysfunctional markets. It's juts the fact now if you want to carve out some exception for dysfunctional markets I'm not sure how you define them.

Mr. Keach: Well counsel again going back to the context that Mr. Butler created which is we are trying not so much to interpret the current statute but to figure out what to do, what's the best approach? Again why wouldn't we want some kind of a system that got a reasonable … and again I think it goes back to what purpose are we trying to accomplish. You are assuming we are trying to deliver a market rate of return to the secured creditor I don't think that's constitutionally required. Let's assume we are just trying to make sure the secured creditor is not hurt by the delay in the return to the secured [crosstalk 01:09:21].

Mr. Phelan: That's adequate prediction.

Mr. Keach: You are assuming that that's necessarily a bad thing?

Mr. Keach: All right but I'm not, I'm not assuming that, so let's assume that our goal in mind is to make sure that the secured creditor is not harmed by the process. We are not having to determine a market rate of return. Wouldn't some kind of formulaic approach be better under that circumstance, cheaper and more efficient for the system?

Mr. Phelan: It wouldn't match the value of his collateral. It has to match the value of the collateral that makes sense.

Mr. Markus: Mr. Phelan, it isn't what really comes up in the over leveraged real estate cases and we know there is nobody that's going to make a loan to 100% [01:10:00] loan to value right?

Mr. Phelan: Yeah but you just deferred his loan it's not a loan. If I'm financing the entire right hand side of the balance sheet that's not a loan, it's financing and it's not interest, it's rate of return. If I'm going to do that you get into the blended rates situation and that makes perfectly good sense. If I'm financing the entire right side of the balance sheet it's not a loan, it's financing.

Mr. Markus: Right but again you want to have so called market do some, kind of metric that doesn't really exist.

Mr. Phelan: It does exist, oh boy it does exist. I finance right hand sides of the balance sheet all the time, everyone the investment bankers up there does the same thing. It's that blended rate that's how they get there.

Mr. Markus: I understand your point but I think that the problem is when you do that you are just inviting a scenario that can never have a feasible plan.

Mr. Phelan: Sure you can. You just have to have the economics.

Mr. Markus: The way the cap rate will set up on the real estate there is no chance that property will be able to pay off that instrument that you are talking about has to be payable. Because the cap rate is going to be much different than what's going to be required to pay off the premium because the way you do this blend you are going to say there is a 60% instrument and a 40% mezz piece that mezz piece is going to pay so much higher there is no chance any of these plans will ever be feasible [crosstalk 01:11:13].

Mr. Phelan: The debtor lost in a capitalistic society. If you can't pay the value, you don't [inaudible 01:11:18].

Mr. Markus: Then what we are basically saying if we cap that approach though we are saying there is no chance to do a reorganization of an over leveraged real estate unless there is a huge equity contribution isn't that the problem?

Mr. Phelan: Not necessarily because you look at facts of things. I mean *Texas Grand Prairie* and Joe knows more about the nuts and bolts of the facts than I do. Coming out there is nothing that says they couldn't pay that higher interest rate. I've been in cases where the higher rate could have been paid as a matter of fact, the court found in *Texas Grand Prairie* that if it was the ... they argued mootness. He said no I ain't moot these guys can pay the higher rate and the plan will not go [inaudible 01:11:56] tank.

Mr. Keach: Counsel can you take a minute and wrap up.

Mr. Phelan: Yeah.

Mr. Keach: Thanks. [01:12:00]

Mr. Phelan: Profit is part of determining value. For the Supreme Court and the other courts to say profit doesn't count, ignores the statute and ignores reality. To fix chapter 11, my world, the statute should be amended to state that the lender will receive deferred payments of a present fair saleable market value of the value of the collateral. So it's clear that a market rate of return is required because that by definition finance 101 is the only way you get to value. For chapter 13 it's a different world. The statutory should be the same, market value. To address your problem, Mr. Keach, for chapter 13 there may be there is additional considerations. You can't have valuation here and it's on the deferred payments as a practical matter.

Most of the times the parties agree on the rate. If necessary however by statute of the rule or standing order U.S. trustee can periodically perhaps once a month survey the published rates for auto and home loans and determine an average rate for borrowers in that district. Those rates will be the presumed rates for auto and home loan cram-down plans. A debtor or lender can always challenge the rate and have a hearing but those presumed rates would be a lot closer to reality than one to 3% over prime.

This issue is a good example of the weakness of our common law system. You get one court that gets it wrong comprised of nine people, I always thought this but I checked it last Wednesday never took a finance or accounting course in their life and here not being exposed to the financial commercial system in the United States at all. One court gets it wrong and then it gets incrementally worse with subsequent decision *Till* we get down to Judge Grey who is a smart guy and says I live in the United States. I live in the Second Circuit with *Valenti* and I have to do [01:14:00] this thing that makes no sense.

Mr. Keach: On that point I'll have to cut you off. Probably saving you from contempt. All right thank you both very much we'll now move to our third question and I understand that some people may have to leave and we thank you very much for your contributions. Our last question of particular interest to trustees, debtors and liquidating trustees among others. Should third party defendants be able to assert the *in pari delicto* defense against the trustee in bankruptcy and would the answer be the same or different with respect to the debtor in possession or other representatives of the estate. Arguing this particular question Mr. John Penn from Perkins Coie and Ron Peterson from Jenner & Block. Mr. Penn.

Mr. Penn: Members of the Commission, thank you good afternoon. I'm assigned the task today of actually advocating against the position that was taken by our working group. I would be remiss if I didn't first congratulate Mr. Peterson on receiving the King award yesterday from the Commercial Law League. However he is entirely wrong [laughter], third party defendants should be able to assert the *in pari delicto* defense against the trustee in bankruptcy, the debtor in possession and any other estate representative. This is a proposition that has been recognized by every circuit court that it has gone before.

The Ninth Circuit had a chance but they bailed out recently on a statute limitations issue. There is not even a split in the circuits.

Mr. Keach: Well Mr. Penn, borrowing from Mr. Phelan's recent commentary on the fallacy of the courts, again given that we have the ability to write on a clean slate, why should we make that mistake again? [01:16:00] Why does it make any sense at all that the creditors of a bankruptcy estate should suffer because we are artificially imputing the knowledge of insiders who have committed a wrong to an independent trustee?

Mr. Klee: Particularly when a receiver would not be subject to the in pari delicto defense. Why should a bankruptcy trustee be treated any differently than a federal receiver?

Mr. Penn: The position that is being argued is essentially advocating the Willie Sutton rule. Because prohibiting the in pari delicto defense basically is doing that for the same reason that Willie Sutton used to rob banks, going where the money is. If you prohibit it just because you want to expand the liability to third parties for creditors then you are actually creating property rights that don't exist under state law and liabilities that don't exist.

Mr. Klee: That's not Mr. Keach's point. His point is as a matter of federal equity it makes no sense to have an estate representative who represents the collective interest of the innocent unsecured creditors, tarnished with the wrongdoing of the debtor. If a federal receiver could assert this cause of action without being subject of in pari delicto, why on earth should a bankruptcy trustee be treated any differently. They are both representing collective interests?

Mr. Penn: Because as a fundamental rule you take the debtor where you find him.

Mr. Klee: Exactly and if the debtor were brining this law suit nobody on this Commission would quarrel with you, the debtor would be subject to in pari delicto. The debtor is not doing this, it's a bankruptcy trustee who's doing this on behalf of creditors. [01:18:00]

Mr. Penn: In doing so the question becomes what is the cause of action.

Mr. Klee: It's the debtor's cause of action.

Mr. Penn: The cause of action for …

Mr. Klee: It's the cause of action that the debtor can't bring because of in pari delicto, but if you and your secured creditor clients levied on that cause of action, and now you wanted to bring it as big bank, you'd say in pari delicto, shmelly delicto, that was the debtor, that's not me I got the cause of action. It's a personal defense it doesn't run with the land, it doesn't run with the cause of action.

Mr. Penn: Well there are other ways to get there and that is with an assignment that has been recognized by the Forth Circuit. You can assign the causes of action to the trustee.

Mr. Klee: If the debtor assigns the causes of action to the trustee then in pari delicto would fall?

Mr. Penn: Well if the creditors, the independent creditors that were injured assigned it to the trustee…

Mr. Klee: Well that's creditor causes of action, we are not going to talk about those. We are just talking about the estate's cause of action. Now we are talking about it when it's asserted by a bankruptcy trustee or an estate representative in a litigation trust.

Mr. Penn: Correct. What we still haven't heard is what is the underlying cause of action?

Mr. Klee: Breach of fiduciary duty, aiding and abetting breach of fiduciary duty, fraud in the inducement, fraud in the factum. The bank designed a scheme to transfer earnings from one quarter to another through swaps and derivatives to deceive the public. They came to the debtor and they marketed it, they sold it to the debtor and they financed it and they got liens on the property and now there is a bankruptcy.

Mr. Berman: Or the accounting firm turned its back on the red flags of the fraud and signed off on an unqualified [01:20:00] audit, knowing that the audit wasn't properly done.

Mr. Penn: In that instance then what you really have a good question becomes who is harmed. If the …

Mr. Berman: We've already said the party that was really harmed are the unsecured creditors who were taken along.

Mr. Klee: Yeah they were sucked in because the true condition of the debtor was not known because they kept rolling these earnings over through these derivatives. They were mislead and they extended hundreds of thousands of dollars or millions of dollars of unsecured credit as this company was kept alive and deep in its insolvency.

Mr. Penn: In that situation the creditors usually don't have that cause of action. Because for a number of reasons, including the fact that they were not the recipient of any kind of advice and why should the accounting firm if it was also lied to, in that situation, be the unlimited guarantor?

Mr. White: Let me ask this question, a hypothetical: suppose the professional firm that's being sued for being complicit in the activity, asserts the in pari delicto defense is that equitable is that fair of perhaps say one of the partners of that professional firm is sitting in prison because of its complicity? In the fraudulent activity that harmed the creditors?

Mr. Penn: The question also becomes was there a separate independent cause of action that existed.

Mr. White: Well let's just talk about equity for a second and does that seem fair to the creditors?

Mr. Penn: Well the fact that there is another source of funds that being the professional firm, in their liability policy, doesn't mean that they should always be responsible for everything that occurred?

Mr. White: Well what I just talked today will strongly suggest that they actually [01:22:00] were complicit and the only reason they are not liable is because of the in pari delicto defense. Is that fair?

Mr. Keach: Just to put a slight twist on that and ask the question directly, what policy objective is furthered by preventing bankruptcy trustees from having the same right that federal receivers have which is to bring these causes of action not based with the IPD? What's the good that's coming from barring these causes of action from being brought by the representative of the unsecured creditors?

Mr. Penn: One thing that it does do is it provides a level of certainty that professionals and the insurers of those professionals can know what liabilities they are exposed to.

Mr. Berman: They are exposed to that liability anyway. All you are doing with IPD is throwing out the ability to have that cause of action …

Mr. Berman: Examined by anybody and how is that fair to the disenfranchised creditors who've lost the money?

Mr. Penn: Well you've …

Mr. Berman: Your right to defend yourself is still there but by using IPD as a shield you don't have to defend the facts and you leave the unsecured creditor sitting out with an empty bucket, how is that fair? Back to Commissioner White's question where is the equity in that?

Mr. Penn: Because the other side of that coin, is that you also create a situation, if you strip the in pari delicto defense of where a crook, if you will, could go out and retain all kinds of professionals. Then file the bankruptcy to then turn states evidence if you will [01:24:00] to then use those as the pot to pay the creditors.

Mr. Berman: That would be an interesting concept because I've yet to see it.

Mr. Brandt: I guess the simple point I think some of us are trying to make is making the allegation is not the same thing as succeeding. I think many of us can buy into the in pari delicto defense as it applies to management. If you take that neutral third party fiduciary who's been appointed, why would you seek to input to he or she the deeds of the previous management which actually was the reason for he or she's installation to run affairs of the debtor?

Mr. Penn: Because the target if you will …

Mr. Brandt: Happens to be a professional firm.

Mr. Penn: Had to …

Mr. Brandt: What if it was a girl's scouts just by way of, you know I mean.

Mr. Penn: The target had to deal with and dealt with whoever was in place at the time and so.

Ms. Whyte: So what, Mr. Penn the truth of the matter is if the firm, for instance say an accounting firm, was negligent and did not carry through on the kinds of requirements they as a professional firm where supposed to, why shouldn't a third party be able to go and sue them and recover? A third party being the trustee.

Mr. Penn: Because you still end up in the same place and if they did the job.

Ms. Whyte: I said they were negligent.

Mr. Penn: Right but they still did the job that they were called upon to do. [Crosstalk 01:25:46]

Mr. Klee: Why does it make any sense that if they did this for a bank the bank receiver can sue them but if they do it for a manufacturing company the bankruptcy trustee can't?

Mr. Bernstein: One of the dilemmas here is if you think about the reasons [01:26:00] for the in pari delicto defense it's so that a wrongdoer can't profit from their own misconduct, right? The debtor engaged in this conduct they can't go sue someone who is a co-conspirator and get a recovery. That debtor was acting on behalf of one stakeholder at the time they were acting and the question is, should that defense also be assertible against other stakeholders after an insolvency?

Mr. Penn: To the extent that the other stakeholders whether it's other management or other shareholders had the ability to protect themselves from that, then they are the ones that empowered the crook to be in that position.

Mr. Keach: Mr. Butler has a question, Mr. Penn and then I'm going to give you, because we've been interrupting you a lot, give you a couple of unfettered minutes to wrap up, Mr. Butler.

Mr. Butler: Mr. Penn I'd like to take this a slightly different direction and get your counsel on something. Assume for a minute just assume hypothetically that the Commission for equity and other reasons was inclined to either modify or abolish the IPD rule. Do you see from your perspective have a point of view of how that should be applied? Should it be applied to creditors committee, debtors in possession, trustees, litigation trustees under a federal plan. There are a lot of different people that fall under that rule right now. Will you counsel if the Commission came here and said you know what we are uncomfortable keeping it the way it is we are going to make a change. Should we make it against all … should we relive IPD from all those entities or would you distinguish one from another?

Mr. Penn: Understanding that that's a departure from my assigned task [01:28:00] or my assigned position and acknowledging that fact. Then under that assumption I would think that you should recommend modifying it as to some but not all. In particular, if you had a debtor in possession that had been the wrongdoer and they remained in place, then there is no basis to modify the in pari delicto defense because the bad actors would still be the same witnesses that would be there to testify about what occurred.

Mr. Brandt: What if you modified it for only neutral fiduciaries or their equivalence, not management not creditors nobody who wasn't installed as a fiduciary either on a confirmation basis or by order of the court specifically let's say a trustee?

Mr. Penn: Understood which is why I was about to turn. If you are under Commissioner Butler's assumption making that change into the extent you are bringing in a separate independent disinterested under the standards that we are all familiar with…

Mr. Brandt: You can add good looking too.

Mr. Penn: Third party trustee then at that point, I could see Congress saying as a policy matter, that's the kind of person that the in pari delicto defense should not be applied to.

Mr. Keach: Mr. Penn thank you. I told you I'd give you a minute of unfettered time to wrap up and I will if you want it so.

Mr. Penn: Well I do appreciate the question just as I'm sure the Commission appreciates [01:30:00] the assignment that I have.

Mr. Keach: We very much appreciate the answers as well.

Mr. Togut: You've been very convincing.

Mr. Penn: The assignment was arguing against the position that our working group recommended.

Mr. Brandt: You do that so well I might add Mr. Penn it's just we were almost persuaded.

Mr. Penn: I do think what you also need to consider is that there will be unforeseen consequences well beyond just a simple bankruptcy including how that will affect professional liability insurance coverage and policies. Because the one thing of which I am absolutely certain is that if the in pari delicto defense is modified, with the exception of perhaps Commissioner White and the professors in the room, every other person in the room is a potential target.

Mr. Keach: On that happy note, thank you [laughter] and I mean that sincerely thank you very much. Mr. Peterson. Don't think you are going to get off easy just because we beat him up.

Mr. Peterson: I have no pretenses.

Mr. Peterson: I rise to my feet to oppose the resolution that is before the Commission. I have submit to the Commission a counter revolution, a counter resolution … [laughter]

Mr. Keach: We are all part of the counter revolution.

Mr. Peterson: Also I refer to the Commission the white paper done by the honorable Steven Rhodes that was submitted to the Commission in March of 2013. It is the position of my working group that this rule should be repealed as to trustees for two reasons. One we have a terrible financial problem in this [01:32:00] country with the financial frauds and that having the trustee in a uniformed form, in a uniform action is the best way to address that problem.

Mr. Klee: Why isn't the best way to handle it through the Justice Department through criminal forfeiture and the enforcement of the criminal laws?

Mr. Peterson: Well number one in the history of tort law it was taught to me by Professor Posner, when we bring tort actions we are acting as private attorney generals. There are only so many resources the Department of Justice has and if you have been waiting as I have been waiting in the *Petters* case for the remission process and criminal forfeiture to take place, you know that that is like *Waiting for Godot*. Not only that, but under the criminal forfeiture statute they can take that money and simply build a bronze stature the Eric Holder and give nothing to the victims, that's why.

Mr. Keach: I'm certainly not advocating a bronze stature of Eric Holder. [Crosstalk 01:32:57]

Mr. Keach: One point that's been made I think we've touched on, one of the arguments that's been made from time to time including by some of the free marketeers who advocate this position is that during the period of the fraud, in fact the unsecured creditor body has been a beneficiary of the fraud. Often times the company has been artificially propped up by virtue of the very fraudulent activity that's now subject to attack. One of the arguments that's been made and I'd like you to comment on it, is that in fact if we now allow a recovery for the benefit of the collective group of unsecured creditors, we are actually allowing a double counting in their favor. What would be the response to that point?

Mr. Peterson: I speak to you not as an academic or passive observer, but as the trustee and chairman of the creditors committee of the country's second largest Ponzi scheme the Petters scheme. Let me give you every assurance that for those who made profit at that Ponzi scheme I sued them for a call back and recovered over $100 million. [01:34:00] In addition to that, Judge Posner opinion about two years ago advocated the rising tide method for calculating claims to eliminate that double recovery that concerns you. This really is beside the point of whether we should have an in pari delicto rule or not.

I will submit to you that having a unitary form and a unitary plaintiff serves four purposes. One, the basis of in pari delicto is lost and no longer needed when you have an independent person suing. Two the purpose of tort law is fulfilled, three the purposes of the Bankruptcy Code are fulfilled and fourth of all, judicial economy.

Mr. Klee: That might be true if you were asserting creditor causes of action, but here it is the debtors cause of action and at least some of the courts have said that there is no standing on the part of the debtor to bring it. Because the debtor is complicit in the fraud, why should the rights in bankruptcy be any different than the rights outside of bankruptcy? Why should some of the bank defendants be put in a worse position just because of the bankruptcy?

Mr. Peterson: Well I think for two reasons. We are here to determine whether the law should be changed so what has happened historically should not be of great relevance. Number two we are here to maximize the recovery for creditors and also to deter those who have not acted properly from future conduct.

Mr. Klee: We can maximize the recover for creditors by taking money from the Jenner & Block retirement plan, but that doesn't mean we should do it. We have to look at the causes of action that are property of the debtors estate and we have …

Mr. Peterson: What are those causes of action? In too many of these cases that I have dealt with and particularly the *Petters* Lancelot case we have had professionals who should have been gatekeepers who either turned a blind eye to the nefarious conduct of the debtor. Or, in even worse cases, offered a helping hand, and why shouldn't they be made to pay [01:36:00] for their failure to discharge their duties and their complicity in the fraud that was committed against the public?

Mr. Klee: Well under non-bankruptcy law, if the state law states that they should pay then the debtor will have that cause of action and they should pay. Even as

Commissioner Bernstein pointed out, there is a doctrine that when two people have dirty hands you don't use the court system to let one thief sue another. Why should it be that the debtor that was complicit in the fraud and maybe was the instigator of the fraud, now all of a sudden goes into bankruptcy, gets a mantle and can sue somebody that they couldn't sue out of bankruptcy?

Mr. Peterson: The proposal which I left with you says that debtors in possession should not be able to bring such actions and should be subject to pari delicto.

Mr. Klee: Okay why is the debtor in possession any different than a trustee? The debtor in possession is charged with all the rights and responsibilities of a trustee why should that matter?

Mr. Peterson: For the reason you just stated, they may be tainted with the very fraud on which they are seeking relief whereas a trustee is an independent agent.

Mr. Klee: If they changed management then they should be able to bring the cause of action?

Mr. Peterson: Well the appointment of a trustee is a bright line, change in management is a gray and fuzzy one that could take years, particularly in Minnesota, to be resolved.

Mr. Butler: Mr. Peterson let's go to another part of your recommendation which was that we should consider statutory trustees in bankruptcy and persons representatives appointed under a plan of reorganization. For example a so called litigation trustee, we should consider them in the same way and we should give both of them a relief from IPD?

Mr. Peterson: That's correct.

Mr. Butler: Isn't there a tangible difference those two actors?

Mr. Peterson: If it were up to me as a statutory trustee I would have said limited at the statutory trustees but I think was the consensus of my working group to include contract trustees because they were so common in many of the cases that are filed in this country.

Mr. Butler: Do you see a difference between the two and if so what is … ?

Mr. Peterson: I really don't.

Mr. Butler: Well let me just explore some facts [01:38:00] just because you are appointed trustee in a case, doesn't mean the debtors can't confirm a plan. Let's assume we have the statutory trustee the debtors confirm a plan which provides the liquidation trust and the debtors management, the people you wouldn't otherwise let have this cause of action, now select a litigation trustee and put that litigation trustee in place, would you feel differently about that litigation trustee versus the trustee statutory [inaudible 01:38:26]?

Mr. Peterson: The proposal on your desk says that if a debtor appoints a successor that he should that successor should be subject to pari delicto that's in our four point proposal that you have up there.

Mr. Klee: Well your proposal contains a lacuna, there is nothing about the creditors committee during the case, you talk about trustees you talk about post confirmation representatives of the estate. What about the creditors committee itself what if it seeks to sue on the debtor's behalf?

Mr. Keach: Again just remember the standard would have been that the debtor by definition the standard here would be that the debtor in possession had unjustifiably refused to bring the cause of action, correct?

Mr. Peterson: That's correct.

Mr. Klee: Right court order authorized it.

Mr. Peterson: I have a little more angst about creditors committees for the reasons that you have raised, which is that some of them may have been on the deal and have their own hidden agendas, trustees tend to be more neutral.

Mr. Keach: Mr. Peterson just to again to explore these boundaries if we have a trustee suing for simple negligence or pre-petition negligence cause of action. That trustee is subject to the contributory negligence defense that might be applicable in state law, why should we treat IPD differently than we would treat say contributory negligence statutes?

Mr. Peterson: Well I think the primary reason is that the purpose behind it which was to keep one highwayman from recovering against another highwayman for an accounting is not the same when you have a trustee who was perfectly innocent and independent. I'd refer you to what Judge Posner said in the Scholes versus Lehman opinion. That the appointment of an independent entity removes the evil [01:40:00] spell and the corporation always no longer the zombie.

Mr. Keach No but my point is that we don't allow we don't do the same laundering when we are talking about negligence. If the debtor pre-petition has simply been negligent, we don't say then that when the trustee sues that the trustee is not subject to contributory negligence defenses by the other side.

Mr. Peterson: Those defenses are legal defenses, pari delicto was equitable defense and it should not …

Mr. Keach: Then why does it matter?

Mr. Peterson: Well an equitable defense should only be applied when it is equitable to do so.

Mr. Klee: Haven't some courts interpreted it to be standing?

Mr. Peterson: That is the case in the Second Circuit and again if you would to adopt the working group's proposal, the statute would change and the standing issue would disappear.

Mr. Berman: There has been a move a foot to say that creditors should bring the causes of action themselves because they are harmed, what's your opinion to that?

Mr. Peterson: Well I think there is three things wrong with that: number one is since the time of Julius Caesar both in military and in litigation, dividing and conquer does not achieve the purposes of tot law. Which is the maximize recover and deter wrong doing. Dividing and conquering is what every defendant wants to see happen and the bankruptcy system and the unitary system we are proposing would avoid that. Number two in some states if you are suing an accountant and the accountant didn't come to your home and go through the financial statement with you there is an accountant shield law. Which means that if a pari delicto motion was granted, it is a get out of jail free card and a death warrant for the injured victims. Number two …

Mr. Keach: Mr. Peterson I'm going to ask you to take about two minutes and wrap up because I know Mr. Gerdano is about to get the hook out on …

Mr. Peterson: I don't want that to happen. I also want everyone to remember in terms of bankruptcy policy if we were to adopt a suggestion of my colleague, we would have a violation of that policy. What happens if the shareholders bring an action in the rocket docket [01:42:00] of the Alexandria division of the Eastern District of Virginia and they get a judgment first and the poor creditors file their actions in the Central District of California? All of a sudden we have a situation where the equity got paid and the creditors got nothing. That violates vertical equity.

Any time you have a foot-race some creditors are going to win and some creditors are going to lose and you are going to have unequal distribution which is contrary to bankruptcy policy. In terms of judicial administration, getting rid of this rule will assure judicial economy, it will eliminate inconsistent results. You'll be able to take advantage of nationwide service of process that's available in the bankruptcy system. Venue issues will not arise like they do in class action litigation, 1409(a) takes care of that. For all those reason and because there is millions or billions of dollars worth of victims, out there, we urge this Commission to take away the get out of jail free card, so that the purpose of both bankruptcy and tort law can be maximized by letting a unitary independent party bring actions in a unitary form, thank you.

Mr. Keach: Thank you. I want to thank all of our advocates today that this was incredibly helpful. Thank you very much and I want to thank all of you for your attention.