ABI Commission to Study the Reform of Chapter 11

November 7, 2013 Field Hearing

CFRP/Wharton School of Business

Philadelphia, PA

Robert Keach: Welcome to this field hearing of the ABI Commission to Study the Reform of Chapter 11. As co-chairs of the ABI Commission to study the reform of Chapter 11, Al Togut and I thank the ABI, the TMA, and the Wharton School, and the host teams behind the corporate restructuring competition and the CFRP for accommodating the hearing today and for assisting in the identification of and coordination of today’s witnesses.

We’ll hear from witnesses today on a number of topics related to plan formation, prosecution and confirmation, including presentations on the debtor in possession’s duties regarding the formulation and prosecution of a plan, section 524(g) trusts, the absolute priority rule, the new value corollary, market testing of equity sales and new value contributions, section 503(b)(9) issues and complications, and the sale model of reorganization via section 363, particularly as it relates to small and middle market businesses.

Al and I would like to begin with some very brief remarks about today’s field hearing, and then we’ll hear directly from the witnesses. The long version of our opening remarks which includes what the Commission has been up to over the last year or more will be posted on the website in conjunction with the transcripts for this hearing.

A little bit of context for today. Since the Second Circuit’s *Lionel* decision and reaching a peak with *GM* and *Chrysler,* the so-called sale model of reorganization has been controversial, but it may provide an effective means of preserving going concern value as well as jobs and tax bases particularly in middle market cases that cannot bear a longer more expensive process. Similarly, with the controversy over so-called gift or class skipping plans, the continued efficacy of the absolute priority rule has come under a spotlight. Is it necessary or useful under the current system of transparency and creditor democracy?

After the Supreme Court’s multiple decisions and several recent forays by the circuits, we also are still uncertain as to the viability of the new value corollary as an antidote to the absolute priority rule, and when the right to contribute new value and/or purchase the equity of the recognized debtor and the amount of new value required must be market tested, and if so, how?

Also at issue, what is the debtor’s duty when it comes to negotiating and prosecuting a plan? Is the debtor a fiduciary at all in that respect, and should we legislate around that point? These and technical and policy issues rising under sections 524(g) and 503(b)(9) as noted will be discussed today.

We’ll hear a short presentation from each of the witness panels. This first panel is a single witness panel, although Mr. Salerno is also sitting in for Professor Kuney, and will be playing the role of Professor Kuney later as well. Then we’ll ask that witness panel to take questions. We’ll excuse that panel and then start that process over again. We’ll hear preliminary remarks from the entire panel before the Q&A’s start.

Al Togut: Before we do that, I just want to mention that we have a bunch of committees, they’re all posted on the website, that are studying various topics. These field hearings are extremely useful to us because we’re able to receive testimony. What you are telling to us will be considered by the Commissioners in formulating the policy that we end up with and the report that we end up with. In addition to your testimony, we state at every one of these hearings, we’re accepting written submissions from people who would like us to consider their points of view, and we very much appreciate you being here.

Keach: With that, Mr. Salerno, we usually give our witnesses five, but you’ve earned a full ten today since you’re Professor Kuney as well, so please get started. Thank you.

Thomas Salerno: Thank you. I’m a member of this Commission’s Committee on Plan, Process, and Substance and I greatly appreciate the opportunity to be here today to address this Commission. I’m also, as you’re aware, the bearer of some bad news because Professor Kuney, who was supposed to be here with me is stuck in Atlanta because of a weather delay, so while we can all appreciate the importance of what we’re all doing, apparently Mother Nature had other plans for Professor Kuney. With this Commission’s approval, I will give a few comments from Professor Kuney’s very lengthy and detailed written report.

I’d like to start with the submission that I did, and there are four areas, specifically, that I addressed. Should the bankruptcy code be changed to first, create a statutory duty of a debtor to negotiate a plan; second, to create statutorily defined fiduciary duties which would be imposed on a debtor as part of those plan negotiations; third, create a statutory structural process whereby plan negotiation is a prerequisite to Chapter 11 relief? Similar, if you will, to what’s done in chapter 9 where, as a prerequisite, you have to show that you negotiated in good faith. Finally, should the Bankruptcy Code be changed to further limit a debtor’s exclusivity period under the bankruptcy code to propose a plan?

Currently the Bankruptcy Code creates no express duties on the first three items that I mentioned and as we’re all aware, in 2005 BAPCPA, changed the exclusivity rules which used to be open ended to produce essentially a hard 18-month cap or hard stop on exclusivity so that it must terminate within 18-months, of course subject to shortening [the period] in the court’s discretion.

Gentlemen, I’m an experienced bankruptcy practitioner. By experienced, I mean old, I suppose. I represent in my practice clients in all parts of the capital structure in distressed business enterprises. I would strongly urge this Commission not to attempt to advocate Code changes that would create statutory duties, fiduciary or otherwise on a debtor with respect to negotiation of a plan or to create any sort of preliminary prerequisites on good faith negotiation in order to be eligible for chapter 11 relief. Any exercise in the creation of these types of Code provisions, I would respectively suggest, would be an exercise in imprecision.

In the late 1980’s, we all saw the real estate meltdown. There have been many meltdowns over the last 30 or so years, but there was a very severe one, certainly, out West where I am primarily doing a lot of my work, and there were thousands upon thousands of real estate enterprises, not just homes, but commercial real estate enterprises which were filed on the eve of foreclosure. That was the very common assessment or a common standard operating procedure at the time. Of course, secured lenders would attack these filing immediately as being filed in bad faith thereby attempting to get stay relief or otherwise get conversion or dismissal of the case.

Well, in the words of the late Honorable Lawrence Ollason from Tucson, Arizona, “There’s no such thing as bad faith, just varying degrees of good faith.” While, that is light hearted there is, in fact, serious substance to that because in truth one person’s good faith is another person’s bad faith depending upon whether you agree with me or disagree with me. All we have to do is take a look at what’s unfolding right now in the chapter 9 proceeding in the city of Detroit, which I recognize is *sui generis*. That’s an extraordinary circumstance, but that having been said you see the sort of things, “You didn’t ask me nicely. You didn’t say ‘Mother, may I?’” The sort of things that are coming up about whether or not you negotiated in good faith just creates ancillary litigation.

To grade duties and to try to put them in a Bankruptcy Code, I believe, will create huge amounts of ancillary litigation. It’s going to use up already finite resources that we have for administration of these cases because we’re going to be fighting, essentially, over whether we even should be at the table, and at any point in the process we’re going to be creating yet a new remedy for potentially disgruntled creditors or anyone, creditors, equity holders, whoever it is, to come up and say to the court they’re not negotiating in good faith anymore.

I would suggest to the Commission that the Bankruptcy Code already has sufficient remedies and sufficient avenues to address these sorts of problems. If it’s not broke, please don’t try to fix it because I think the fixing in this circumstance will create more litigation and more skirmishes than it will in any way deal with.

On the issue of exclusivity, here is where I would urge a change in the Code, and one that goes back to pre BAPCPA days. I would suggest and I would respectively request that this Commission consider changing the Code so that there is no hard stop, if you will, on exclusivity with respect to a debtor. Any hard stop is, by definition, artificial. Deals in cases, commercial cases, and I’m not just talking about the large commercial cases, but mid-market cases and even the smaller cases. These things happen in their own time, and to try and attempt to force a deal with a predetermined time line does not lead to better deals. In fact, all of us who have been doing bankruptcy law and commercial bankruptcy law know that the quickest deal is not always the best deal for these cases. For the debtor, for the creditors, it’s just not always the way.

When you’re setting hard limits and you’re trying to force people to come to a table, what I believe you’re trying to do is legislate economics. Deals happen because of the economics or not, and when you attempt to set a deadline you’re going to attempt to legislate the economics.

A number of years ago I was involved in rewriting the insolvency laws and the restructuring laws for the Czech Republic, and they were doing it as part of their admission to the European Union. They had had a number of amendments to their laws within the years before that, and each amendment strengthened creditor’s rights, but they were perplexed as to why it is that creditors were not having greater recoveries out of these cases. Once such change required as a condition to approval of any plan of restructuring, they called it a plan of arrangement, that the debtor provide for a 20% recovery over two years to these unsecured creditors. Without that, even if creditors wanted it, the court could not approve it. That was an example of attempting to legislate economics. There was a percentage of recovery people get, the timeline in which a deal is struck is not a question of legislative fiat it’s a question of the economics of the deal.

To attempt to artificially limit exclusivity to force a potential dilatory or unscrupulous debtor to come to a deal, I would suggest, is going to throw out the baby with the bath water. If you ever try to create legislation to deal with the dishonest debtor, the unscrupulous debtor, the dilatory debtor, what you’re going to do is punish the honest and diligent debtor equally with the dishonest debtor. There are other places in the Code that deal with the dilatory debtor and there are other people in the process, committees, secured creditors, U.S. Trustee. There are other people in the process that can bring this sort of information and this sort of dilatory tactic to the court, and you can get stay relief, trustee appointment, limiting or terminating exclusivity regardless of when, in fact, it’s set to expire, if at all. I would respectively request this Commission not attempt to create artificial fiduciary duties or other duties. The marketplace will allow that to happen and to the extent that we have dishonest or unscrupulous debtors, there’s other parts in the Code that already deal with that. Any attempt to do otherwise, I believe, is going to create ancillary litigation which is just going to continue to increase administrative expenses of bankruptcy estates.

I thank you for your time with respect to these topics.

Keach: Thank you, Mr. Salerno. Let me acknowledge Commissioners who have questions. I have some, but I’ll give the floor to others who want to go first. Bill, did you have a question?

Bill Brandt: Mr. Salerno, my only question is for years I’ve practiced in the arena too, and I tend to see exclusivity as an overblown concept. I’m not at all in disagreement with your perception that a hard stop at 180 days is somewhat meaningless. I’ve often wondered since we are now seeing many [section] 363 sales, why exclusivity at all since virtually all of these appear to be a financial play the moment they get there? What is the difference for the creditors if the debtor is the only person who can file for the 180 days, or literally upon the impact of the case somebody can step up, fund the estate and offer a recovery to the creditors quickly? One of the concerns I have about that is the pressure we seem to see is about the professional fees related to the operation of cases. The longer the case goes the bigger the fee issue, so why exclusivity at all, if you could speak to that?

Salerno: That’s a legitimate question. Why exclusivity at all? It’s my belief that exclusivity serves a very valid part in the process. If we assume, and I think we must, that in most cases we’re going to see a lot of secured debt. Not simply unsecured debt, but a lot of secured debt. The truth is without exclusivity I think the people that are being injured are as much the unsecured creditors as it is the debtor, if you will. The debtor sometimes is just a gatekeeper at that point, if it’s insolvent. If the debtor has no ability to otherwise buy back in old equity such that they’re going to buy back into the reorganized debtor, then I think the exclusivity, in fact, assists much more the unsecured creditors than it does the debtor.

At the outset of a case, it’s very simple for a creditor to file a type of plan. We’ve all seen it with a secured creditor - that plan is a liquidation plan. We’re going to file a liquidation plan. We’re going to go to an auction sale at confirmation. We’re going to credit bid our debt, and we’re going to move forward. We’re going to do that through a plan that may or may not create more value. We don’t know, but that having been said that’s a very easy plan to file. Without exclusivity, I believe the debtor will be completely bypassed and I think the people that will be hurt by that, not only the debtor, but the interests of the general unsecured creditors.

Keach: Mr. Butler and then Mr. Seery.

Jack Butler: Mr. Salerno, I’d like to explore again your recommendation regarding, following Mr. Brandt’s conversation, the exclusivity question and I want to pause at something for your feedback and thoughts, and that is if we eliminated the hard stops at 18 months, but instead replaced them with a change in the evidentiary standards that say, for example, after 12 months a debtor would have to demonstrate cause by clear and convincing evidence as opposed to just preponderance of the evidence, so that to retain exclusivity it’d have to be a really good idea or there’s a really good reason for it. So that in the obvious cases where there are not objections and where the committee supports, and so forth probably, you meet that standard, but you don’t necessarily meet it in the contested cases where maybe preponderance isn’t enough. Under this scenario you would keep preponderance of the evidence as the legal standard to terminate exclusivity. What’s your reaction to that kind of an approach?

Salerno: I mean it’s certainly an interesting approach. Whenever we start talking about evidentiary standards I have to admit that I always kind of view that a little bit with skepticism for this reason. If you talk to any experienced bankruptcy judge and say “We’re going to put evidence before you. Is it preponderance or is it clear and convincing?” I think bankruptcy judges kind of have a feel for how they think the case is going along, and of course that’s completely discretionary with the trier of fact. The trier of fact being a bankruptcy judge who’s going to be one of the most sophisticated triers of fact in these areas that you’re going to find.

I would suggest that putting the issue of whether it’s preponderance or clear and convincing that we already have that because a month into the case, six months into the case, a year, 38 days into the case, choose your time, any party can seek to terminate, assuming that we had open-ended exclusivity, any party could seek to terminate, modify, or limit exclusivity. We all know that earlier on in the case that’s going to be a much harder burden for someone trying to terminate exclusivity, but as the case drags on, we’re in a year, we’re in whatever, or 18 months. That becomes harder, so I would suggest that putting the issue aside of just the evidentiary standard, be it clear and convincing or be it preponderance of the evidence, I think in some respects we already have that in the Code. It’s built into the Code, and I think courts will wait to hear from the parties and interests to see what they think is going on because if no one raises it I think the court may say well assuming active professionals, active constituencies, they may figure it’s going along OK.

I don’t have any serious adverse reaction to what you propose, Mr. Butler. I don’t. I mean that would certainly be one way to do it. You build into the system an automatic status hearing, but it’s more than a status hearing, obviously it’s an evidentiary showing. I wouldn’t have any adverse reaction to that.

Keach: Mr. Seery, you had a question.

Jim Seery: Thank you, Mr. Salerno. Along the same lines with respect to exclusivity, I understand your point with respect to a pre-negotiation in the litigation we’ve seen in Chapter 9, and I understand your point with respect to fiduciary duty and the risk of additional litigation regarding the debtor’s acts post-petition. I don’t understand that second point with not having some end to exclusivity. If the debtor doesn’t have a fiduciary duty to negotiate in good faith, to put forth a plan within a time limit and there’s no hard time limit, doesn’t that shift all the burden to the creditors to terminate exclusivity to put forth a plan that could move the case forward and give the debtor more negotiating power to take out value that might go to, effectively, a lower class than it would if they have to move expeditiously within that finite 18-month period?

Salerno: I think as a general proposition you may be correct, but I would suggest this. If you look at almost every commercial case there is, there’s other limitations on a debtor and their ability and their timelines to move forward with a plan. Exclusivity is not the only one. For example, is cash collateral used, debtor owned possession financing? A lot of these things have deadlines built into them as well. We frequently see cash collateral stipulations that’ll be on a 30, 60, 90-day timeline and at the end of that the cash collateral consent is going to terminate. In which case there’s that thing that’s pushing a debtor to move forward. It’s not like a debtor who files a chapter 11 can sit on his, her, or its hands and decide I’m doing nothing until such time as people force me to do it. I suppose there are some cases like that, but I think usually the other parties in the process who have some serious leverage, such as holders of unexpired leases or other parties to executory contracts, they can come in and push this debtor to be doing things that they should be doing anyway.

I think putting into the Bankruptcy Code a fiduciary duty or any sort of statutorily defined duty, I suppose you could do that, but I would suggest that the system already accounts for it. The system already accounts for it because it gives remedies, and you’re right, it does shift a burden, if you will, but I think that’s probably not a bad thing that it shifts that burden to the creditors. Judges in my experience have been pretty sophisticated about the way they see things. They’ve seen a lot of cases and they kind of get a feel for when a case is doing what it’s supposed to be doing or not.

Seery: Is your complaint with the termination of exclusivity at 180 days, is it the time or is it the fact that it terminates at all? Because I took it to be the latter, which I think would be a tremendous shift of burden to the creditor body as opposed to the debtor body.

Salerno: I think you’re right. My concern is that there’s any hard stop at all. I remember prior to BAPCPA there wasn’t a hard stop. It was open ended. United Airlines had exclusivity for what, three years? A long period of time. Again, in large cases maybe you need longer and short cases, in smaller cases maybe it can be shorter. I think whether you put two years on it, a year, 18 months, whatever you put on it I just think it creates an artificial deadline and I don’t think it’s necessarily going to force people to come to the table. They’re either going to come to the table or they don’t, and if they don’t come to the table there’s other ways in the Code to deal with it because you know you all talk about exclusivity and while it’s true from a debtor’s perspective you certainly want to preserve it in order to force people to come to the table and talk with you and deal with you. At the same time, certainly on a true restructuring plan, for a non-debtor to propose a real restructuring plan it can be very difficult. It can be very difficult. There’s a lot involved in doing that.

Of course a liquidation plan, which is the most common plan I think you find when exclusivity terminates. I don’t think it’s a “I think I’ll keep the company alive and I’ll do this, and there’s going to be new money coming in.” I think the most common plan you find are secured creditors filing liquidation plans which are essentially I’ll take the collateral back, we’ll do a sale, and we’ll do it that way. I think that’s probably a more common sort of thing.

Keach: Mr. Togut.

Togut: Yeah. We’ve had witnesses come before us and say pre-BAPCPA worked just fine. We’ve had the experiment now with the post-BAPCPA amendments, and we should go back to the pre-BAPCPA days. Several of the Commissioners then ask, can you site some examples that demonstrate that the post-BAPCPA deadline hurt a case?

Salerno: Hurt a case?

Togut: Hurt a case. Right? You’re telling us we should eliminate the time limit. Can you site any cases for us where the time limit actually was hurtful, so we should get rid of it?

Salerno: Well, it’s a good question, but here’s what I would suggest to you. If you look at what has happened certainly since fall of 2008 when the capital markets melted down. When you take a look at what the large chapter 11, even the mid-market for that matter, chapter 11’s that have been filed since then. They’ve almost all been to implement a section 363 sale of all or substantially all the assets. As a result of it we haven’t had a lot of what I call true restructurings certainly since 2008.

I recognize BAPCPA has been involved or been out there since 2005, so I would suggest that the operative time period would not be 2005 to today. I think it’s really 2005 to 2008 because we’ve just seen very few true restructurings. If you think about it, if you get into a case you immediately sell the assets. I know that’s a whole separate area of concern or discussion, but if you immediately sell the assets at that juncture, exclusivity becomes kind of secondary. Presumably you got a pot of money, and you just question how you’re going to divvy it up. I think exclusivity becomes a whole lot less of a concern.

I would suggest, from my perspective, that eventually the capital markets are going to loosen up on availability of money that we are going to, hopefully, see real restructurings again as opposed to simply sales, and under those circumstances I believe it will be damaging. Can I give you specific examples right now? No, I cannot. Not as I sit here today.

Togut: Thank you.

Keach: Mr. Salerno, I’ve got a question from your paper and then one I just like you to comment on something from Mr. Kuney’s paper, but just in terms of the example, I think *Tribune* actually had an exclusivity fight that was a bit expensive as I recall, but as you point out there haven’t been a lot. From your paper, your position is let’s not change the fiduciary duties of debtors and possession as they exist now, at least as they relate to the negotiation of plans. In the sense of let’s not make a more defined and more stringent duty with respect to plan negotiation.

In your paper you cite one of my favorite cases, *Water’s Edge*, which I think is a decision by Judge Queenan, if I’m not mistaken. In which he points out that debtors don’t have a fiduciary duty when they’re negotiating plans. They’re free to negotiate the best plan they can negotiate. That approach has not always been taken, however, by every circuit and by every district, so I would actually sort of flip your paper in one sense and ask you should we change the Code to statutorily incorporate Judge Queenan’s *Water’s Edge* standard so that it’s clear because it’s not in the cases that when debtors are negotiating plans they’re not under the same sort of duty of loyalty that some people have argued, which then leads some people to argue that there’s an irreconcilable conflict that debtors have.

Salerno: I think my biggest problem with changing the Code to try and put in a statutory definition of fiduciary duty or otherwise create a fiduciary duty is exactly, I think, what you’ve hit on which is every debtor in possession is inherently conflicted. They’re inherently conflicted. If a company is truly insolvent, for example, the secured debt exceeds the value of the enterprise. On a true, true, true, true fiduciary basis wouldn’t that suggest that what you really should do is simply turn it over to the secure creditor. Here, take it.

What usually happens, and we see it all the time, is that through the process, through exclusivity as part of that process, in my opinion, what happens is value gets created, if you will, or actually gets taken from the secured creditor and it moves into hands of other people that in the true scheme of things are truly out of the money, and I don’t think there’s anything wrong with that, but to me if you try and define this fiduciary duty or these duties I think the ancillary litigation you’re going to create is the property’s over leveraged. It’s not, “you know, I guess ten years from now maybe the value of this is going to be more than that,” but for right now you shouldn’t be carrying anyone’s water you should be simply be handing the property over to us. That’s my concern with it.

Keach: My proposal would be to go the other way though. I always thought the genius, in Judge Queenan’s opinion was that he recognized, and Harvey Miller has taken the same position, I think, in some of his writings and I think he’s right about this, is that debtors in possession don’t negotiate and prosecute plans, debtors do. Debtors in possession have a fiduciary duty with respect to the maintenance and preservation of the assets and the maximization of their value. Debtors are the ones who propose plans to divide that value, and they don’t have the same duty.

My question really was should we actually make that bifurcation of roles clear in the Code?

Salerno: I would have no problem if the Code attempted to do that, and I would suggest to you right now, why do we need to change the Code at all with respect to this? It seems to me that that’s the practice. I recognize there is a case here or a case there that creates those issues, but in practice I think that’s kind of the way it’s understood to work anyway. We can change the Code to make that formal delineation, if you will, you certainly do that, and I wouldn’t have a problem with that necessarily because I think that’s the practice.

Keach: All right, let me get back on one thing in Professor Kuney’s paper that I would ask you about. There are many things we could ask him about, but the one in particular I’d like you to focus on. In Professor Kuney’s paper in his reforms around the sale model of reorganization, one of his proposals is that if a chapter 11 is filed to sell substantially all the assets, if that position is taken by the estate early in the case, he would have a mandatory appointment of a trustee to oversee that process. Do you have any thoughts on that recommendation?

Salerno: I do, in fact, have some thoughts on that recommendation. I’m here as a reporter for Professor Kuney’s paper.

Keach: You don’t have to defend him if you’d rather not.

Salerno: I believe that I would never support anything like that. That presupposes that a trustee, for example, would be able to create or even get the same value through what they bring to the table that existing management would bring to a table. People that know the industry, people that know the business. There’s a delay inherent in bringing somebody in and they’ve got to get up to speed. It’s not like they come in and next day they’re ready to go ahead and turn around and sell this business if, in fact, it needs to be sold at that level, at that time period.

I don’t think that is a viable suggestion and I think that will have the law of unintended consequences. The consequence, however, the intended consequence of that is we’re bringing in this objective third party, so to the extent that there’s better value to be recognized for restructuring this third party with you ax to grind comes in and says “I’ll make that determination.” They make sure that there’s no insider deals and all that stuff. Those are all laudable goals.

The unintended consequence is the very person you’re bringing in with no axe to grind and no real basis in the business is also probably the person that’s least able to maximize value if, in fact, it’s going to be through a sale process. A quick sale process, if it needs to happen. If it’s something that can happen a year from now that’s a whole different story, but a lot of these cases, the so-called melting ice cube cases, that we see all the time and we do see. I’m sorry, I think a trustee is not the person to come in and to be able to respond and maximize value. That’s my opinion. I don’t think it’s because of lack of competence. I think it’s a lack of background and a lack of knowledge about that particular … those assets that they’re selling.

We’re not putting them up on an auction block. What is my bid for these widgets? We’re talking about, usually, whole sections of companies, whole operating divisions of companies. That’s not the sort of thing you just put on a website and say “Do I hear $100 for this?” It’s a lot more complex than that.

Keach: The underlying presumption of the paper seemed to be that there is almost always insider dealing or something going on that needs to be dealt with and that seemed to follow naturally from that presumption, which seems to me may be mistaken, at least in my experience. It seems to me that in those cases where that seems to be a problem we found ways to solve that with sale monitors, examiners, and the like. Perhaps we could do some legislation around legitimizing the sale monitor in appropriate cases, but trustees seem to me a little bit extreme.

Mr. Butler, you had a point.

Butler: Yeah, I want to go back to the fiduciary duty discussion because what troubles me about this debate, and I’d like to hear your reaction on, is the suggestion that debtors as opposed to debtor in possessions don’t have fiduciary duties. I don’t know where anyone gets that view. I happen to agree with and accept the concept that when someone is negotiating a plan they do so as a debtor, but those debtors, certainly if they’re corporate debtors for example, have state law fiduciary responsibilities. They’re run by state law fiduciaries who have state law responsibilities established by the corporate law of the states of which they’re incorporated, and they need to fulfill those responsibilities whatever they may be. Would you agree with that?

Salerno: Yes, I absolutely do agree with that. I did not mean to suggest that debtors or debtors in possession do not have fiduciary responsibilities. My concern is they already have those under applicable non-bankruptcy law. They already have those, and I fully agree with that. We all know what they are, particularly in an insolvency situation. My point is they also have a duty to maximize value and to try to get value to as many different parts of the capital structure as possible. Outside of bankruptcy that may violate their fiduciary duties outside of bankruptcy, but the process in bankruptcy we often see value going to people lower down the chain as part of getting the deal done. I don’t think there’s anything wrong with that.

If I misspoke I apologize, but I’m not suggesting they don’t have fiduciary duties. Of course they do.

Butler: I bring this up simply because whenever this debate goes on people are focused, I think, on the issue of should there be another federal fiduciary duty law created which is something the Bankruptcy Code has shied away from, right?

Salerno: True.

Butler: As opposed to saying the Bankruptcy Code takes the state law fiduciary as it comes to the court. Wherever that, assuming you have the debtor in possession model, fiduciary comes from. If they come from Kansas, they have Kansas law controlling them. If they come from California, they’ve got California state law controlling them. If they’re a Delaware charter corporation, as many are, they have Delaware law. I just wanted to make sure in terms of the record the debate here, unless there’s a disagreement, that we’re talking about the fact that in the planned negotiation, I think what I hear your testimony saying is don’t import chapter 9 into chapter 11. Don’t try to change the eligibility standards. Don’t have these artificial constraints. Don’t try to impose a federalized fiduciary set of requirements on the plan formulation process, but you’re not, at the same time, abandoning whatever the state law fiduciary responsibilities might be.

Salerno: You’ve correctly stated my position. The state law fiduciary obligations come in. That absolutely is true. I’m saying don’t add yet another layer. To add another layer, a federal layer, I just see that as being not workable, but I fully agree with what you said. We’re having a heated agreement, Mr. Butler.

Keach: Yeah, and I think the Queenan distinction is really designed to say the debtor’s negotiation of a plan about how to divide the assets does not inherently conflict with its duty as a debtor of possession to maximize value, but those things are not irreconcilable.

Butler: I would argue, and I hear this argument from Mr. Miller all the time, it does not alleviate the corporate debtor, at least the corporate debtor from its state law fiduciary responsibilities that it may have under state law to maximize value or to do whatever it may have to do with respect to the res that is owned by the corporate debtor.

Togut: Yeah, but isn’t the distinction that nowhere in chapter 11 does it require a debtor to get creditors the greatest return, and I’m not sure that the debtor in possession has an obligation to maximize value. I think the debtor in possession’s obligation is to preserve value. Preserve it. To safeguard and protect the assets, but so far as I understand nowhere in chapter 11 is there a maximization requirement.

Butler: Imposed by the federal statute as opposed to whatever those directors may have to do under applicable state law.

Keach: Mr. Salerno, another question for you arising out of Professor Kuney’s presentation, but something I know that you’ve spoken about before, so I’m not hesitant to ask you. In his presentation he has said the same thing that a number of people have said to us which is we acknowledge that the sale model of reorganization is with us to stay, but what we need to do is attack quick sales where there’s not enough time to achieve the maximum value.

Then I always come back to the same question which is how do we finance that extra time? Do we need to modify concepts of adequate protection? Do we need to look at surcharging liens? Do we need to look at carve outs? It always comes back to how do you distinguish between the legitimately melting ice cube and the ice cube that’s melting because somebody has a blowtorch on it, right?

Salerno: Sure.

Keach: What are your thoughts on that?

Salerno: Well, I think regardless of why the ice cube is melting it’s still melting, and someone may have a blowtorch on it in a sense that I have a loan I had secured by the assets. That loan is in default and asset values are declining. I am going to aggressively push, as a creditor, for stay relief, for a [section] 363 [sale], so I’m going to aggressively do that. Arguably, I’ve got the blowtorch on the ice cube, which is melting it down which is putting pressure on this debtor to do it.

I think this concept of is there a legitimate emergency or not, I think that is something in fact in Professor Kuney’s paper on which he has a very specific recommendation. He wants to modify the law to have a number of showings that need to be made to show there’s a legitimate emergency. What did you do to market the assets beforehand? I read through all that, and I said, from my perspective I said that’s pretty much what I would do at the evidentiary showing before I went in to seek a [section] 363 sale anyway. I think most experienced bankruptcy lawyers would. They wouldn’t just go in and say “I want to sell it. Here it is.” They show all those things because all those things help the judge get comfortable with the fact that this is a melting ice cube. This isn’t something we just woke up Monday and said, “I got to sell it Tuesday.” You’ve been looking at it. You’ve tried to market it. You’ve done this. You’ve done that. I think the way it’s financed, currently of course is through DIP financing and it’s usually a so-called loan to own where some lenders say “I’ll lend to bridge it through a sale.” There’s a definitive time line for this sale to occur, and that money’s going to have to be paid back through a sale or through a credit bid or however it’s going to be paid back.

If you’re asking me do I think that there are other alternative viable means such as, for example mandatory surcharge or mandatory carve out? I suppose you could attempt to do that, but I think that would wreak havoc, serious havoc to the concept of secured creditor’s rights if a secured creditor does not really want the sale. If the secured creditor wants the sale they should pay the freight, as it were, to get it to the sale process because they benefit from that.

Keach: Right, and let’s just elaborate on that point a little bit because maybe that’s the standard which is, I guess a number of judges have said on various points “Give us the ability to say no.” The issue is that if the secured creditor or the other constituencies want the sale that’s usually because there’s a premium to be achieved by a [section] 363 sale process that could not be achieved by virtue of putting together a series of state law foreclosures, article 9 sales, whatever your alternative is. In a multistate enterprise, that’s a daunting proposition obviously.

Is there a mechanism under which we can give the judges the ability to say no and to test that resolve which is, in other words, find that premium? Should there be a showing that has to be made for a sale inside of a 60-day window or a 90-day window that requires the showing of a legitimate pre-*Lionel* type emergency not being caused by an exercise of lender discretion. Is there a standard that we could find there?

Salerno: It sounds to me like what you’re proposing is requiring a debtor to come in and show that the melting ice cube is something other than the fact that property is over-encumbered. That the secured lender will not lend any further and will not forebear any further, and wants to aggressively defend its rights. If that’s the emergency that somehow that should be treated differently than another emergency which is it’s really depreciating in value for whatever reason, so actually depreciating in value.

Keach: It’s a warehouse full of frozen food and the power is off.

Salerno: That certainly is a possibility. My suggestion would be this. If the asset is a going concern business that has employees, that has real live expenses, not just I got to keep insurance around a piece of property that has no building on it. When you’ve got a real asset that’s an operating business, those operating businesses are going to require capital to keep going in the way of some sort of line of credit in order to get people, if it’s an operating business, get lender to get vendors to continue to ship to you. We all know those sorts of tugs and those sorts of pressures that are put on debtors when they try to keep it going.

If the lender says “I will do the DIP financing so that the vendors will continue to ship to you. You can pay your employees on time. You can do all those things that you need to do to preserve this going concern, but the cost of doing that is there’s going to be a [section] 363 sale in 60 or 90 days.” Whatever it is, 30, 60, 90 days, you would take that out of the true emergency situation. What are the debtor’s options at that point? Well they can go see some alternative form of DIP financing, but presumably they’re going to want to come in and prime the existing lender. That’s no walk in the park, as we all know. This lender’s already underwater and now you’re going to put some more money on top of that to push down.

I think if we do that maybe one of the consequences is going to be that you’re going to get liquidations anyway, they just may not be as pretty as [section] 363 sales, which we all know are not always pretty, but I think they’re going to be even less pretty if we try and take that out of the equation of what’s an emergency. What’s causing the ice cube to melt? That’s just my impression of it.

Brandt: Let me blend all this together for a second and going back to where we started. I’m channeling Commissioner Togut here when I do this. I love all of the legal arguments, but I look at the public policy issues and I see where this is going. One of the things that we start off when we talk about the Commission was the law. The present code was written before cell phones, before laptops. I mean we’re dealing with an anachronism that needs some updating, and we’ve all admitted around here and your testimony has gone to the fact that virtually every debtor gets to a point of a filing well under water, and the commercial markets have changed such that all lending is virtually secured and none of us can think of a debtor that filed recently with a significant amount of unsecured credit available for leveraging purposes and the rest of it. Maybe in the mega cases, but certainly not in most cases.

So here we have a situation, when you deal with exclusivity that I’ve always viewed exclusivity, and I channel Commissioner Levin when I say this, that it’s one of the inducements to get a debtor to file. If you can get in bankruptcy quickly and not resist the temptation to wait until the last moment, I’ll give you 180 days or 18 months, whatever it is of exclusivity, and use the unsecured portion of obligations you have behind your secured debt to somehow work with that and file a plan. That was the operating condition in 1978. The commercial markets have changed, so when we talk about exclusivity I have a head scratcher here because I go back to channeling my fellow Commissioner Togut. If the debtor really files a case, literally underwater in most cases to secured lenders, and there’s really not a possibility of getting free assets anywhere in the future on which to fund a plan or to jam the lender down and come up with something for the unsecured credit is you’re doing a one-on-one with a secured lender going in, and I would be the first person to agree with you that perhaps we should exclude lender liquidation plans off the top. If they want to file a plan they put something on for unsecured creditors, a sort of an inverse surcharge.

I have a problem with the exclusivity period all the sudden, which I never thought I would because I’m pro-debtor because everything’s under water and there is no real hope of finding that one string or that pin tube of assets beyond the commercial lien up and are we keeping it only as an inducement for people to file?

Keach: Well, let me throw another comment and then you can deal with both of them at the same time because I’ve never understood the exclusivity period as an inducement for debtors. I’ve always understood the exclusivity period as keeping creditors honest. In other words, creditors won’t negotiate with somebody who they can wait out, essentially. The parallel I think, and it’s very hard to prove a negative and find test cases, but the parallel is in single asset cases, and that is this, when you’re in a district or in a circuit where you cannot separately classify the deficiency claim and you cannot sort of set up the vote, in other words so that the secured creditor has a veto, my experience is those secured creditors don’t negotiate.

On the other hand, when the debtor does have a plan opportunity they do. My sort of feeling on exclusivity, and it seems to me this is inherent in your recommendation not to cap it, is that it’s a playing field leveling device for debtors. It gives them something that they can negotiate with.

Salerno: Yeah. I think that’s exactly right. I mean, Mr. Brandt, I never considered exclusivity as being an inducement for a debtor to do anything. I’ve never considered it that. What I’ve always viewed exclusivity as is a way to force parties to come to a table. To force them to come to a table because when you get parties around a table you may not get a deal done.

Brandt: In other words, pay me so I don’t have to wait so long?

Salerno: It’s both a shield and a sword.

Brandt: You just talked about all the sales and the issues and responded to Bob’s comments on Professor Kuney’s paper. If everything’s a sale is the concept of pay me so you don’t have to wait so long really good valuable public policy?

Salerno: Well, if we’re going to amend the Bankruptcy Code, as you suggested. Because today, what we’re looking at are a bunch of sales and we think they’ll never be true restructurings in the future I understand your point. I’m hoping that that’s not the future of bankruptcy practice otherwise we’ve all become very highly paid auctioneers, and I would hope that’s not the future of bankruptcy practice. If it is, if what we are ultimately saying is chapter 11 restructurings are a thing of the past. I think the concept of exclusivity becomes utterly mute, frankly.

Brandt: I’ll be brief. I’m coming from the other direction. I think none of us want to be nothing but glorified auctioneers moving the metal, but if exclusivity was gone where people could step in and you had to put something on the table for the unsecured creditors or you had to actually confirm a plan if you wanted to take over the case. My thought was at least it’s a lot better than just queuing up [section] 363 sales. At least you’d have some idea of getting others involved. They knew that they could get in if they had a better idea. Show me what you got.

Salerno: I guess, Mr. Brandt, are you arguing that there should be no exclusivity at all in a case and just let anyone come in and file a plan at the outset of the case?

Brandt: I would assume if they wanted to file such a plan, Mr. Salerno, they’d have to put value up to get votes. I’m just being political here, and putting value up to get votes or liberating value to get votes, to get enough votes to make the plan work indicates to me that somebody might release the torrid of value quicker than the debtor would in order to satisfy a lot of people to get a plan vote.

Salerno: I don’t know why you think they need to get votes. They need one accepting impaired class under current law. The secured lender who puts up the plan is their own accepting impaired class if they’re not an insider you. They don’t need anyone else’s [vote].

Brandt: Well as Reagan once said “We’re not here about current law.” That’s the point. We could change that.

Keach: The thing I would come back to is this, and I’d tie it back to the discussion we had about fiduciary duty and then your time will be up and we’ll let you off the hook.

Butler: I had one more question.

Keach: One of the real reasons to keep exclusivity in addition to leveling the playing field is that you put the initial plan formulation in the hands of the entity that, as Mr. Butler points out, actually has duties to people. If you take away exclusivity and let anybody do it then the plan proponents become people who don’t have those duties, and you have a wholly different device in your hands. That’s a comment not a question. Mr. Butler, go ahead.

Butler: Just one quick question. Taking your testimony at face value that the sales process is here to stay and that we should recognize that there are mechanisms and benefits in which it should be permitted to proceed. There are some bankruptcy courts who have become increasingly concerned about the due process associated with the self-created emergencies. The benchmarks that appear in financing documents. Liquidity being used as a weapon in the first day or five days or ten days of a case, and there are rules being considered now and local rules being considered now that would have just black line rules. For example, you can’t have bidding procedures approved on less than 21 days’ notice in a case except in extraordinary circumstances, and extraordinary circumstances are specifically not lack of financing or benchmarks imposed by a lender, so there is at least a minimum period of time for other parties to be able to focus on what’s put into bidding procedures because sometimes the whole game is in the rules, not in the actual auction. What’s wrong with that concept? What’s wrong with just saying that there has to be, other than the truly extraordinary, there has to be a minimum amount of time.

Salerno: I don’t think there’s anything wrong with that. I’m not arguing that there is anything wrong with that at all. I think that makes sense. To me, if that were in the Code then what you remember the big debate over central vendors, critical vendors? That once a couple of courts allowed it that became the norm. Everyone said, “I’ll only ship if I’m in your critical vendor list.” Then you go through all this stuff, and then when courts did a hard stop, said, “We are not approving.” They didn’t put it in the Code, but when you had courts that said “We are not approving critical vendors. Don’t even ask.” Guess what? People shipped anyway. I have zero problem with saying if in fact [section] 363 sales are here to stay or even if they’re not given that how many of them are out there, putting in some very specific provisions which provide those sorts of protections. I don’t have any problem with that at all because I think what’ll happen is that the lenders that said before “I won’t lend you. You’ll die on the vine. You’ll die the second day in the case.” When it says this is in the Code they’re going to say, “OK, well I guess I got to lend for that.”

I’m not being glib about it, but I think that’s what lenders say, “These are the rules of the game.” And they’ll go with the rules of the game. I have no problem whatsoever with that as a concept.

Keach: In fact, some of us have been around long enough to know that that actually used to happen. Mr. Salerno, I want to thank you for your testimony. It’s been incredibly helpful and we’re going to move on to our next panel. Thanks very much.

Salerno: Thank you.

Keach: I’ll just as a real quick reminder as I said to Mr. Salerno, we’re going to take all of your preliminary remarks first. We’ll do the whole panel. Then we’ll do the Q&A, and we’ll direct questions at individuals, but we may ask you all the same question as well. Unless you have decided in advance on an order, and if you have tell me what it is, otherwise we’ll start with Ms. Chavez-Ruark and move across the table.

Maria Ruark: Good afternoon. My name is Maria Ruark and I’m a partner at Saul-Ewing in its Bankruptcy and Restructuring practice group. Thank you for this opportunity to address you.

As you are aware, in 1999 the United States Supreme Court issued its decision in the *203 North LaSalle* case. In *LaSalle*, the Supreme Court added a requirement to the new value exception that new value plans may not provide existing equity holders with exclusive opportunities free from competition and without benefit of market valuation because they violate the absolute priority rule. The Supreme Court however, declined to rule that a new value corollary to the absolute priority rule exists and did not specify what constitutes the requisite market testing.

The Commission should seek to modify section 1129 of the Bankruptcy Code to address some of the practical and legal questions that arose as a result of the *LaSalle* decision. I will address three of those questions today, the first two very briefly and the third in more detail.

First, I recommend that the Code be amended to recognize a new value corollary to the absolute priority rule. The Supreme Court first recognized the concept of the new value corollary in 1939 with its decision in *Case v. Los Angeles Lumber*. In 1988, in the *Norwest Bank v. Ahlers* decision and in 1999 in the *LaSalle* decision the court declined to rule on whether the new value corollary does in fact exist, but in both of those decisions the Supreme Court engaged in an analysis premised on the assumption that it does in fact exist.

The overwhelming majority of courts considering new value plans, either assumed without any analysis that a new value corollary exists, or affirmatively concluded that a new value corollary exists. A handful of courts have declined to recognize the new value exception.

Whether the corollary exists is not a hotly contested issue. The corollary is almost universally recognized. Nevertheless, I recommend that section 1129(b) be amended to recognize the exception and put the issue to rest. The corollary makes sense from a policy standpoint. The underlying policy for reorganization is rehabilitation of the business. The new value corollary recognizes that equity holders who inject new capital into a restructured business are not gaining a position ahead of creditors because of their old equity position. Instead they are taking a concrete step to restore the business to solvency by paying fair value for the reorganized debtor’s equity.

My second recommendation is that the Code be amended to incorporate a market testing requirement. *LaSalle* makes clear that a debtor proposing a new value plan must demonstrate that the equity in the reorganized entity has been tested by the market so that former equity holders are not given a sweetheart deal in purchasing the reorganized entity’s equity. I recommend that section 1129(b) be amended to codify this requirement.

My third and final recommendation is that the Code be amended to define and give parameters for the market testing requirement. In *LaSalle*, the Supreme Court concluded that the debtor’s plan violated the absolute priority rule because the plan provided junior interest holders with exclusive opportunities free from competition and without benefit of market valuation, which is prohibited by the absolute priority rule. However, the Supreme Court declined to state what is necessary for market valuation.

In *LaSalle*, the Supreme Court reviewed only two means of market testing, competing plans and bidding on the reorganized entity’s equity. *LaSalle* was a commercial single asset real estate case and under such circumstances it very well may be appropriate to limit market valuation to these two means, however; the Supreme Court declined to determine whether those mechanisms would be appropriate in every chapter 11 case or whether there may be other means for market valuation. In fact, the Supreme Court appeared to recognize the need to determine market valuation on a case by case basis when it emphasized in a footnote that its holding in *LaSalle* does not suggest an exhaustive list of the requirements of a proposed new value plan.

The Supreme Court appears to have left the decision as to whether the market was sufficiently tested to the bankruptcy courts evaluating debtor’s plans, and rightfully so as the circumstances surrounding each debtor in each plan of reorganization are different. Some courts applying *LaSalle* have concluded that the two means of market testing discussed in *LaSalle*, termination of exclusivity and an opportunity to bid on the debtor’s equity are the only ways to satisfy the market testing requirement. This interpretation however, is not consistent with the *LaSalle* decision.

Courts concluding that every new value plan violates the absolute priority rule unless the bankruptcy terminates exclusivity or the plan provides for an auction of the reorganized entity’s equity dramatically overstate the holding of *LaSalle*. In *LaSalle*, the Supreme Court merely suggests that terminating exclusivity and soliciting bids for the equity are two ways to test the market.

Undoubtedly there are many ways a debtor can test the market, and whether the market has been tested is a factual inquiry. It should not be anything but a factual inquiry as each business debtor in bankruptcy has a different market that must be tested in different circumstances to consider.

I recommend that chapter 11 be amended to state that market valuation requires a two part analysis. First the debtor must demonstrate to the bankruptcy court that it has identified and targeted the appropriate market, and second the debtor must demonstrate that it has in fact tested that market. In my written statement I recommend that the Bankruptcy Code be amended to confirm that the market for the reorganized debtor’s equity has been tested if (1) the exclusive period has been terminated (2) parties and interests and/or third parties have been given the opportunity to bid to purchase some or all of the reorganized entity’s equity, or (3) the debtor has introduced sufficient evidence for the court to conclude that the market has been tested.

I’m going to revise that statement and suggest that the Code be amended to provide that the presiding court should determine whether the market has been tested, which may or may not include termination of exclusivity and/or a right to bid on the debtor’s equity. I make that modification for this reason, termination of exclusivity alone may not sufficiently test the market. In fact there are recent cases where exclusivity has been terminated and the court has concluded that the market valuation has not been sufficiently met. With regard to sale of equity, again, that alone may not sufficiently test the market.

I give an example on my written statement where a debtor has a provision in its plan that its equity will be put up for auction as part of the plan confirmation process, and the only person who bids on that equity is existing equity, and they bid a dollar. If you take the cases applying *LaSalle* very strictly to mean that there are just two means of testing the market then that would mean that the absolute priority rule has been satisfied because the market has been tested, but if someone is showing up and paying a dollar for the debtor’s stock or stock in a reorganized entity and the stock is actually worth more than that, then that can’t possibly be a fair market valuation.

In practice we see that most creditors do not have the financial ability and/or interest in proposing a competing plan or purchasing the reorganized debtor’s equity. It’s not something that happens often, but when it does misapplication of *LaSalle* can be devastating. Each court should be able to examine the circumstances of a particular plan and determine if the market testing requirement has been satisfied.

I recognized that my recommendations do not address all of the issues raised by *LaSalle*. If the Code is going to be amended to incorporate the new value corollary and the market testing requirement, many additional questions must be considered. For example, if the debtor’s equity is to be sold should there be an auction with bid and sale procedures similar to what we see in section 363 sales? Should the sale be at confirmation or earlier? Who can bid? Only parties and interests? How about competitors or others? What about family members and friendly parties who are not creditors? How does the debtor ensure that it has targeted the appropriate market? Does the debtor have to solicit potential purchasers outside of the creditor base? If so, are securities and state blue sky laws implicated, or will registration exemptions apply? If exclusivity is terminated does that create a sufficient market for purposes of market testing? Hopefully some of these issues can be addressed with careful drafting.

It’s important to note that whether the market has been tested as required by *LaSalle* and whether the new value contribution is fair consideration for the reorganized entity’s equity are two different issues. As described in more detail in the testimony of the Honorable Barbara Houser on April 19th of this year, courts considering confirmation of a new value plan must take into account five factors. The contribution must be new, substantial, money or money’s worth, necessary for a successful reorganization, and reasonably equivalent value of the stock being received. I refer the Commission to Judge Houser’s testimony regarding the practical difficulties in applying these factors, and I recommend that the Commission codify these factors in section 1129.

Once again, thank you for the opportunity to address you and I welcome any questions you may have.

Keach: Thank you, and I’m sure we’ll have a few. Ms. Miller.

Kathy Miller: Thank you, Commissioners. My name is Kathy Miller with the firm of Smith, Katzenstein & Jenkins in Wilmington, Delaware. I am here with Courtney Barr of the firm of Locke Lord. We are members of the International Women’s Insolvency Restructuring Confederation, IWIRC. We thank you for this opportunity to present our paper to you. We’d also like to thank our co-collaborators in our paper Jovi Bohan, Kendra Leghart, Tally Wiener, Tinamarie Feil, and the JD candidate Khyshboo Patel.

The Commission heard testimony earlier this year from the members of the National Association of Credit Managers on the importance of the [section] 503(b)(9) claim, and they talked about how important their role is in extending credit to the debtors as they are approaching bankruptcy and how important that claim is to them and having comfort in continuing to provide that very important unsecured prepetition credit. Our paper and our position addresses the procedural processing and filing of those claims. We recommend the adoption of uniform procedures for filing an allowing [section] 503(b)(9) claims. Not only, we believe, will this take away all the confusion and possibly missing deadlines it also is beneficial to the creditors because we believe it will also create more of a market for claims trading for [section] 503(b)(9) claims.

Currently the claims traders can sometimes find out who those creditors may be if the creditors file their claims early, but with the process we are proposing, we think that market will then also be more available for these creditors. Courtney is going to be addressing the issues and the actual recommendations and what I wanted to address in my statement was how we got there. What were we looking at? What are the problems that the creditors face now?

[Section] 503(b)(9) claimants are high brief claims. They truly are prepetition claims, but by the Code they are given an administrative treatment. Because of that priority there are additional burdens put on those creditors. A post-petition creditor having the admin claim has to file, under the Code, a request or a motion. For these prepetition claims however, they can be of varying size. It could be cost prohibitive, filing a request. When the Code first adopted [section] 503(b)(9) there was a lot of flurrying of activity after the filing. People didn’t know what to do, so they were rushing into court. “Let me get my [section] 503(b)(9) claim on file. Have the court hear that. Have it allowed.” Many were pushing for payment early. It was unclear how to handle that.

With that flurry of activity in the beginning it started something on three sides, the debtor, the creditor, and the court. At the early stage of the case the debtor is trying to get things stabilized and getting financing and these days, quickly getting through their sale process and dealing with those issues. Having a flurry of motions filed in the beginning of the case distract from that and is also burdensome of the court with the time that that may take.

For creditors, the claim, again, may be too small for them to retain counsel, and very often the cases are not filed in their local jurisdiction so it’s sometimes even getting layers of lawyers to try to get that claim filed. Not only that, but with that there are different procedures in each jurisdiction. Some jurisdictions have adopted rules and another jurisdiction is on a case-by-case basis of motions procedures filed by debtors.

Just some examples, in Maine under local rule, the [section] 503(b)(9) claim is filed substantially in the form and manner as a proof of claim form. It is served on the debtor or trustee and the United States Trustees office. Objections to that claim are dealt with by another rule. Any motion to compel payment of that claim is controlled by yet another rule. In the Northern District of Illinois a [section] 503(b)(9) claimant may file a proof of claim within the claims deadline set by the court. The instructions will then tell you, you take official form ten and you check the box “other” and then you write in [section] 503(b)(9) claim. A motion for allowance of that claim must be filed no later than the deadline set for the filing of claims, and it must be served on all parties in interest. Again, a cost that could be too cost prohibitive for some claimants. The absence of the timely filing of that motion the claim will lose its administrative priority and become a general unsecured claim. Massachusetts, in its rule, the request to be filed within 60 days after the [section] 341 meeting. Again, if you don’t file by the time, you’re kicked down to a general unsecured claim.

The creditors are left with confusion about what to do in each case. A lot of credit managers become very sophisticated in filing proof claims and can file them all over the country. They know the form. They know how to do it and they get it done. Currently on a [section] 503(b)(9) claim not only does the credit manager or whoever is taking care of filing proof, the claim for that, has to determine each jurisdiction, do I file a motion or do I file a request? Do I wait for a motion by the debtor and where do they want it? Do they want it with court? Do they want it with the debtor? Do they want it with a claims agent? Then you also have to then look a further step, a layer further of are there local rules that can shut me out of the box early? These are the difficulties we find that creditors are facing and the debtors as well with these issues, and that’s what’s led us to our recommendation. Courtney.

Courtney Barr: Yeah. Thanks, Kathy. You know [section] 503(b)(9) claims are sort of strange and I’ve had many of my clients claim that they belong on sort of the island of misfit toys, because they have the characteristics of a regular petition proof of claim, but yet they’re obviously admin claims or they have admin claim priority. As Kathy identified, there are a number of procedural hoops that you have to jump through depending on the jurisdiction, so we thought there was a real need here to establish uniformity for the filing of these claims and for the procedures that are in place to object to and reconcile these claims in addition to transferring these claims.

I’ll be very brief. We offer four suggested changes to the way that [section] 503(b)(9) claims are administered. First of all we would like creditors to be able to use a standard, or a version of a proof of claim form to file their [section] 503(b)(9) claim, so rather than having to file a motion or request for payment with the court we suggest that a separate proof of claim form, a version of official form B10 be created for [section] 503(b)(9) claims in particular. Number two, we would like there to be some form of recognition that the transfer rules and the official forms relating to the transfer of proofs of claim may be used for transferring [section] 503(b)(9) claims. Number three, we would like to see the creation of a default deadline to file [section] 503(b)(9) claims and we suggest that that deadline could be printed upon the notice of commencement of the case, which obviously goes out in the first few days after a case is filed. Number four, we would like to see a uniform procedure for objecting to and reconciling [section] 503(b)(9) claims.

The details of each of those recommendations is found in our paper. I am more than happy to go through them with you now, but I realize we’re kind of close on time.

I guess I would just add then that as to the deadline, to creating a default deadline, we thought that that would be beneficial because it obviates the need for a debtor to file a bar date motion. It also would create some certainty among creditors because they have some idea of when the bar date or when the deadline to file claims is, and we think that it would be beneficial to the bankruptcy courts because there wouldn’t be necessarily a flood of admin claim payment requests in the critical early stages of a chapter 11 case.

In terms of creating a uniform procedure for objecting to or reconciling [section] 503(b)(9) claims we recommend that after the [section] 503(b)(9) deadline passes, the debtor be given a number of days, call it 60 days after that deadline, to file a single report, and in that report which would be more or less a chart form. It would check a box “I don’t object” or “I do object” and give a brief reason why just as you would in a normal claim objection, an omnibus claim objection. After that report is filed, creditors have service of that, and for those that see that their claim has been objected to they would have an opportunity to respond and if necessary there would be a hearing.

Again, our bottom line is it’s a headache for our creditor clients to try and figure out in every single jurisdiction what the local rules are and how you go about properly asserting their [section] 503(b)(9) claim in a cost effective manner.

Brandt: If I could ask a question. I was at the Commission hearing at the NACM and the [section] 503(b)(9) issue was wrapped as well into the concepts of reclamation and preference, which were two other issues. The sort of incipient trade that was coming out was that with [section] 503(b)(9) and let’s say we find a way to do it effectively as you suggest. Reclamation is something that could go by boards or we could just sort of trade it off for [section] 503(b)(9) or better enforcement of that. What are your thoughts on those issues in the interplay?

Barr: Well, I recall reading some of the testimony from that hearing and I believe it was a representative of Kraft that said that in her opinion the reclamation claim was more or less worthless. I think in their perspective they’re fairly worthless, and the reason why is you do run into situations where the secured creditor may claim a higher priority lien to that asset. For instance, when you ship goods does it become inventory that’s then subject to the first scene holder’s liens? Then you can maybe get into fights over whether your reclamation lien has any right to payment to begin with. I think that [section] 503(b)(9) is just a lot cleaner. You don’t have to fool around with the filing the notices of reclamation within the relevant state law periods, and I think you give certainty to the process.

In terms of the interplay between how [section] 503(b)(9) and [section] 502(d) interacts, it’s not something we looked at specifically. I think it’d be a great idea for a follow up paper. I mean I don’t know if Kathy has any other comments as to that specific issue.

Miller: Well, on the reclamation claim, I think in practice it is exactly what the representative of Kraft said happens. No one, hardly anyone, makes a reclamation demand anymore.

Brandt: Right.

Miller: It used to be before [section] 503(9) you would see the type of reports that we’re suggesting for [section] 503(b)(9) done for reclamation to begin a case. There were procedures for that and the debtors would say, “OK here’s the inventory I had on hand today. This is what it’s worth.” These days with most secured creditors underwater there’s no value to them, and it’s not giving the creditors the certainty for them to continue to ship, and they get a lot of comfort in that claim. It’s a claim that more likely than not is going to be paid, and so the whole process in getting the value of that is enhanced by this streamlined process.

Brandt: There was one other issue that came up at the hearing in Las Vegas and that was that the NACM and various testimony was focused on the fact that preferences now seem to be pursued singly for the purposes of going to the secured lender or paying the administrative costs, and the creditor body there, actually the NACM group, thought that was manifestly unfair and thought that they could live with preferences provided the preferences were collected and distributed only to the class from which they claim. What are your organization’s thoughts on that?

Miller: I think they would wholeheartedly agree with that.

Brandt: I bet they would.

Miller: It’s not the reality of what happens. I’m not sure if that would function properly, or you would get that to implement that under the way the practice is now.

Rich Levin: Why not?

Miller: Well, I haven’t thought it all the way through. Right now, somebody could even buy the [section] 503(b)(9) claims.

Levin: Wouldn’t it be possible to simply provide in the statute in some fashion that recovery of preferences could only be distributed minus the actual cost of recovery to the class from which the creditor was preferred?

Miller: You can. I think you could.

Levin: You said you weren’t sure that would work in practice. Why not?

Miller: Yes, it could be legislated that way, that that’s the rule and that’s what you have to do, but then if you look at how is that going to be funded to pursue that litigation, you oftentimes, I think, see [those cases] taken on contingent fee cases, so you could do it that way. You’ll see the secure creditor is going to, or whoever is going to take that asset of those claims off the top, and then as negotiations go forward then they give the unsecured creditors some seed money and then so a litigation trust is going to be set up, and so you get something to start to process those claims.

Male: That process would then change if the statute were changed in this way.

Keach: Right, you could just make preferences non-pledgable. You could make them an asset that couldn’t be given as security.

Miller: Right.

Keach: And that would solve that problem. But you also have to worry about using preferences just to pay the administrative claims you want. Non-preference recovery administrative claims.

Miller: That’s right. If you did it that way maybe it would be a good haul for creditors because then maybe there wouldn’t be the funding to pursue the claims they wouldn’t pursue as much and then those creditors wouldn’t get sued as often.

Brandt: Leading to the next step, [section] 503(b)(9) claims could be the class of creditors for which the preferences are collected to be paid, which also strikes me as perhaps somewhat unfair within that class.

Keach: Well, you could use them to fund the [section] 503(b)(9) payments.

Brandt: That’s why many of the other creditors were, as we discussed this, were thinking “Wait a second, so you want to collect my preference so you can pay the [section] 503(b)(9) claims?” They were balking a bit at that, so your thoughts?

Barr: Yeah, I mean, I know my clients would.

Brandt: Unless they were the recipients you mean.

Barr: Right, of course. I’m assuming that there’s sort of a general unsecured creditor in that case. I guess in trying to enforce that though, I would think that that would kind of create an administrative headache in terms of if you were to prosecute a preference against someone. Is the idea that the money, the preference recoveries I guess, would be put into a pool to then only be designated to a certain class?

Brandt: Sure, less the administrative cost of collection.

Keach: They would be earmarked for distribution minus the admin cost.

Barr: Would that be codified or would that be put in a plan?

Keach: No, it’d be codified. It’d be the only thing you could use it for. It would be recovered in trust essentially.

Brandt: The theory was that under what we’ve been discussing here in the earlier testimony, the world has changed since the Code was written. When you come in and you’re fully liened up,it now appears that the preferences are additional recoveries for the secured lender, which seems to many in Congress as manifestly unreasonable, and so if you’re going to do that you’re not going to fund the case on the back of creditors who offered credit at a time when the debtor probably needed it. So the question was do you restrict the recoveries from preferences to just the class from which they came including separating out the [section] 503(b)(9) claims?

Keach: In part because that’s the fundamental basis of when did you recover them in the first place. Remember the whole basis behind preferences was that equal claims should share alike, right?

Ruark: Another alternative would be to provide that no liens can be assessed against chapter 5 recoveries.

Keach: That would be a start, but then it gets sucked up into the admin claim, right? Of the super priority.

Ruark: Maybe in some circumstances that should happen.

Levin: What circumstance and why?

Keach: The admins can’t otherwise get paid.

Levin: I’m not just talking about the admin super priority claim of the DIP lender, but also the professional fees whether it’s trustee or whatever …

Ruark: Well, if the work has been done by the professionals …

Levin: Well we’re all four professionals here.

Ruark: I know. You’re setting me up here.

Brandt: Because of course if we haven’t done the work, we don’t want to be paid.

Levin: Right. Don’t go that far.

Ruark: If the work was legitimately done and it benefited the estate in some way then the professionals should be paid, and if it comes from avoidance of action recoveries then so be it. That’s estate property.

Levin: What’s your idea of a preference recovery? Creditor was preferred. He got more than the rest of his class. He should give it back.

Ruark: Right.

Levin: To share with the class or pay somebody else.

Ruark: But it comes back. It comes back to benefit the estate. It doesn’t necessarily come back …

Levin: Sure it does now under the statute. What’s the theory?

Keach: Remember, we’re writing on a blank slate now.

Ruark: Understood. It’s kind of hard to reprogram my mind and consider the possibilities.

Levin: That’s what we’re asking for. We’re all for reprogramming here.

Ruark: Well, I think it’s grossly unfair for secure creditors to get those recoveries because when they made their loans and got their liens they did not count on having those recoveries as collateral.

Levin: Maybe they did.

Keach: Not usually at the start of the loan.

Ruark: At some point in time that may have been a consideration, but at the time the funds were advanced that was not considered to be part of the collateral, so I think it should be off limits to secured creditors and maybe an alternative would be for the code to provide that liens cannot be asserted against chapter 5 recoveries.

Levin: Should it also be off limits to the DIP lender?

Ruark: That’s a much tougher question.

Levin: Not really.

Jim Seery: Bob, can I just ask one question? It’s theoretical and staying on the same point. Do you have a sense from your clients as to whether [section] 503(b)(9) is actually restricted credit and contracted it to 20 days as opposed to 30 or 40 if the statute had not been there? Does this provision, as it’s currently written, restrict trade credit before a filing or enhance it?

Miller: You’re saying because it’s 20 days I’m going to keep my credit ceiling very tight for that 20 days?

Seery: Right. If I was at 45 [days] I would take it to 20 [days].

Miller: Right. I haven’t seen, and most of my work is with creditors, I haven’t seen too much of that. It’s more they see it more as the benefit of I have the comfort of that 20 days and not so much cutting off the credit because they know that’s going to be there, and that’s the first thing they focus on when a case is filed. We look at whether or not they’re executory contracts. What their obligations are post-petition, but the very next thing that they’re getting ready to do is when do I get that claim, and it has been more recently with the motions that are filed in the cases of either critical vendor or let’s pay the [section] 503(b)(9) now, that’s given them a lot of comfort. That’s getting money back to them quickly. They are then willing to continue to keep going in giving the credit terms again to the debtor post-petition because in the prepetition period often times they are beyond the credit terms, the stated credit terms, so when they go petition and if they’re not getting that paid they want to tighten that back up, but they’re willing to go back to the credit terms of the practice before the petition because they’ve gotten some payment already. I think it has been helpful.

Seery: In one of your remarks, you also mentioned that if we could streamline the process post-petition for both recognizing and then, I think, ultimately allowing these claims, that would also enhance liquidity because it would give the creditor an opportunity to sell those claims as an allowed [section] 503(b)(9) claim as opposed to something that’s much more amorphous.

Miller: Absolutely. Talk to claims traders and they say now there’s definitely a market for it. They want to buy them, but they don’t know where, they’re not readily able to find them. I get solicitations all the time for the regular proof of claims. We’re not out looking to sell necessarily, but we’re getting all the solicitations because all they need to do is go to the claims agent webpage or the court’s docket and they don’t have that opportunity for [section] 503(b)(9) claims early in a case. You wait for the debtor and they set a bar date. The very end of the case you’re losing that time for them to be able to liquidate that claim.

Seery: I take it if your clients were able to monetize those types of claims, which since they’re admin would be higher dollar amounts or percentage amounts, they would be more likely to extend post-petition credit to that debtor or additional post-petition credit?

Miller: It depends on the size of the creditor. Some of them are saying, “Why am I going to discount at all? I’m going to get paid.” and they can’t afford to wait it out. Some of my clients can’t. That holding out for a year or whatever it may take to get to a confirmed plan to get that [section] 503(b)(9) claim could be devastating to them, so to be able to liquidate that, but then to continue to keep going with this that or to that they can continue their business is very beneficial.

Keach: Well, just to follow up on that and then I have a question for Maria, which will probably be the last question then we’ll take a bit of a break. One of the things that’s regularly done in critical vendor procedures is, we’ll give you critical vendor treatment, but part of the price of critical vendor treatment is you’ll keep supplying credit.

Following up on Mr. Seery’s question, would your clients be interested in streamlined procedures for early payment of [section] 503(b)(9) claims premised upon post-petition extension of trade credit?

Miller: They’d love it. Yeah, if you can get those paid early, absolutely.

Keach: Ok. Ms. Ruark, a question. Going to your *LaSalle* discussion, and remember again we’re sort of writing on a blank slate, so assume for example that, and I think this is true, that *LaSalle*’s market test is statutorily based, so if we change the statute we can get rid of the test if we wanted to. Assume that we want to have market testing. I guess I have a sort of two-part question. One thing that’s always bothered me about the requirement of doing anything, putting something in the plan in advance, or terminating exclusivity in advance, is that in theory you can’t, and in fact you cannot determine whether the absolute priority rule applies until the voting is over with, right? This normally happens in small or middle market cases or single asset real estate cases where some creditor stands up and says, “I have a blocking position and I won’t vote.” In other words, just jump to [section] 1129(a)(8). We’re sort of past that.

The first question is shouldn’t we have something in place in essence to allow the vote to actually happen before we have to kick these procedures into place? Then my second question is, and we just went through this in a case called *Mesa International* in New England, where we actually filed something that looked a lot like a new value plan. It was actually a sale to insiders, but we were sufficiently concerned it might be construed as, in essence, and end around new value, that we simply terminated exclusivity on the first day because I wasn’t all that concerned about the fact that they were going to file another plan. In that district, that was sufficient for marketing, and it’s interesting I think to sort of design plans with auction and bid procedures in them.

We’ve been living in the first circuit with this since *B. Jones Realty*, which actually predates *LaSalle*, I think, with auction procedures and plans. My experience with those, incidentally, is they don’t work very well. You get a lot of litigation around whether your equity auction procedures are fair or whether there’s really been a market. Why shouldn’t we just keep it simple? Assuming we preserve the absolute priority rule and assuming we do what you’ve suggested and codify the new value corollary, which would have the benefit of not having to ever decide again whether it’s a corollary or an exception. Why shouldn’t we just say that all you’ve got to do is terminate exclusivity because again, we don’t have to decide whether that meets the market test or not we could just say that it would? Wouldn’t that just be simpler?

Ruark: That’s one alternative. I think the underlying premise of *LaSalle* is a good one, and that is that existing equity should not be given a sweetheart deal in buying the equity of the reorganized entity. Whether you call it market valuation and you phrase it the way it is in *LaSalle* or you call it something else, that is a concept that is important for the process. Maybe what should be required, and again it goes back to Judge Houser’s testimony where she talks about the five factors to consider in determining a new value plan.

Keach: Let me just step in for a second because mine’s a much simpler point. I happen to think in most of the cases where this is important we’re not really talking about market value. It’s a nice theory by the Supreme Court, but even in *LaSalle* you weren’t talking about market value. What you’re really talking about is there anybody around who will pay more than the insider, right?

Ruark: Right.

Keach: Neither of them is probably paying market value, right?

Ruark: Right.

Keach: In some cases you’re clearly overpaying, but you’re really just trying to find out if there’s somebody out there who will put their money where their mouth is, and it seems to me you could do that a lot more simply just by saying, “Fine.” You propose a new value plan. If the vote goes the way the vote goes then the debtor has an opportunity to provide for new value as long as exclusivity’s terminated at that moment.

Ruark: I like the concept of bifurcating so that you have the vote first. The only concern I have about that is that it could extend the confirmation process, so if there’s a more efficient way to do that, because you know we’re really talking about small and mid-sized cases where timing is critical.

Keach: Right. The way we’ve done it is to put it all in the same plan, right? You have sort of a column A plan, then if the vote goes your way you get it, and if it doesn’t your column B plan is going to confirmation and that’s another way to do it.

Seery: Why is it good and fair policy to have this exception where it’s really, in most of these cases, being done on the back of the secured creditor’s loan? If the secured creditor was reinstated then I could see that being fair. If the secured creditor was paid off then I could see that being fair. Aren’t we just really creating value by restructuring the secured creditor’s terms so that somebody else can get that upside? In many, many of these cases.

Ruark: Well, and the reality of it is if you’re talking about not recognizing this corollary and the option would be liquidation, that’s, in most cases, not in the secured creditor’s best interest. A reorganization is better in the long run for the secured creditor, so that’s where the fairness comes in for the secured creditor. Then, of course, you have the underlying purpose of chapter 11, which is reorganization and rehabilitation.

Seery: Right, but I’m not sure that.

Keach: To go to Jim’s point, it seems to me, this kind of goes to things like automatic relief from the stay provisions. Should the standard be different if it’s a single asset case, say, versus an operating company where there are third parties at issue, employees, etc.?

Ruark: The theme of my presentation maybe didn’t come out so well is that discretion should lie with the bankruptcy courts to examine each and every case based on the unique factual circumstances of that case, so a single asset real estate case for example, you can’t even compare application of the absolute priority rule and the new value exception in a single asset real estate case with a small business chapter 11 that is a mom and pop shop where really the value of the business lies with the relationships between the owners and the community and vendors and the customers.

The problem I have with *LaSalle* is that it seems to present or at least some courts have interpreted it as presenting a very uniform concept, but it doesn’t apply in every chapter 11. There has to be some discretion with the ban if a new value plan should be confirmed, and every case is different. I think it’s if you’re going to try and find a one size fits all for this situation, I encourage you not to do that, but to build some flexibility into the code that allows a bankruptcy court to review each case based on the circumstances of that company.

Keach: Thanks.

Levin: We tried that once. Creditors didn’t seem to like it.

Keach: Thanks. My problem with *LaSalle* is they seem to ignore the fact that you can terminate exclusivity.

Brandt: One of the concerns we had when Judge Houser actually appeared in front of us, one of the concerns she had was that cases were all sales, and we said, “Look, one of the reasons that is, is debtors, mid-size debtors can’t come to you anymore and say, ‘I’d like to file a case, and in the end I’d like to have a reasonable expectation I can come out the other end with my business.’” Which is the essence of the new value issue. I don’t have problem with the market test issue related to that, but can’t we design something under your suggestion, just as Bob says, we wait for the owners to make their offer and if somebody wants to overpay, isn’t it as simple as that rather than about a larger auction process?

Ruark: Absolutely. However this is done it should be done in a way that promotes efficiency and doesn’t bog down the process any more than it already is. I like that concept, whether it should be in a statute or whether it should be in the drafting of a plan, I don’t know, but certainly if it’s in the statute it would give everyone a starting point.

Keach: In the current framework it could be a [section] 1123(a)(5) provision, right?

Ruark: Absolutely.

Keach: But the plan can do something.

Ruark: Implementation of the plan. Absolutely.

Brandt: From a public policy standpoint, I’m backing the Commissioner Togut idea which is what do we get to restructure businesses to get people to come back in and think that they have a chance of keeping their family business or if it’s private, by putting some money on the table and making a deal with the creditors rather than making everything a financial play?

Keach: You have to buy preservation of control. With that we do need to stop. We have another panel. We’re going to take a five minute break and then we’ll come back and do the last panel. We also have a lot of really good questions for that panel, and we want to rest up.

All right. Thank you, gentleman. Sorry for the short delay. Why don’t we start with Professor Brown and then move to Professor Casey, and again, take five to seven minutes, hit the highlights. We have read your excellent papers, which as I pointed out will be part of the record, and we thank you both for them. They were extremely thoughtful and helpful, Professor Brown.

Prof. Brown: Thank you. I want to thank the members of the Commission and Sam [Gerdano] and Michelle Harner for reaching out to me and talking to me about this process, and thank you for the invitation to be here.

Today I’m going to focus on the unique issues that arise in [section] 524(g) asbestos bankruptcy cases. These cases tend to receive a lot more attention in the asbestos community than they do in the bankruptcy community, and that kind of makes sense because there are only four or five of these cases filed a year. Whereas the assets that they set up, the assets that they take out of the tort system can be enormous and have massive implications for litigants in tort system.

As you’ll see in the paper, we’ve seen a number of trusts established since 2000. In the last decade we saw two-thirds of the trusts that had been established put into place. We saw a lot of assets go in and we saw billions of dollars come out almost as quickly. These trusts have become very controversial. There are allegations of fraud in the trusts themselves. There’s been a dramatic reduction in the amount of assets available for future victims. All of that’s in my paper. I’m not going to bore you with reciting all of that again.

My focus today is really more on the implications in a bankruptcy system and in an actual reorganization including the potential here, perhaps, to implement reforms. I’m open to questions about the possibility of either removing [section] 524(g) altogether or adopting a broader system that would incorporate other types of mass torts where it’s based on our experience with [section] 524(g).

When you look at the statute and you look at the way that it actually works you see the statutory goals were pretty clear, both in the legislative history and when you step back and look at how things proceeded before it. This was clearly intended to benefit future claimants, preserve assets for them. It was also, obviously, intended to allow otherwise viable companies to survive, and there was this other thought that if we set up these grid matrix type of trusts then we would be able to pay claims much faster than the tort system.

I’ve addressed each of those objectives in my paper, and I think that with respect to the allowing some companies to survive, I think the record is pretty good on that. Prompt and efficient payment or maybe expeditious payment certainly does seem to be taking place. The one area where I think there has been a dramatic departure from the objectives is preserving assets for future victims, and this study that I completed earlier this year, I frankly was surprised by how much we saw of a reduction in the trust system just in a three year period.

Now the features that I want to talk about specifically, some of them are not that uncommon. Some of them are unique to asbestos bankruptcies, but even the ones that are not uncommon standing alone, when you put it all together they create a pretty unique system for administering a bankruptcy case. We have a futures representative who is a lot like a guardian ad litem in some other proceedings, and yet here, pretty consistently, we see an interested party who has an interest that is adverse to the future victims having a significant role in their selection. Often this future representative will be selected by the debtor, usually in consultation with the plaintiffs, and often with the current plaintiffs actually being the ones who are telling them this is who you’re going to appoint.

The other thing is there’s frequently very little information about these claims available during the case. As I noted, there’s no bar date. In some cases they have gone the way of asking for a plaintiff fact sheet or plaintiff information questionnaires (“PIQ”) which will require a plaintiff to disclose some information so that they have an idea of what the basis for these claims are, which they might not because of the way the pleading takes place in the tort system.

The case I want to just point to here, a recent case, or actually a still ongoing case is *Specialty Products*. When they filed bankruptcy they had about 15,000 claims pending against them. They had a PIQ system set up. They circulated that and they received 2,800 responses, so less than one in five plaintiffs actually submitted a PIQ. Those claims, nonetheless, could have been allowed to go through the system and been part of the voting process, notwithstanding the failure to file the PIQ.

Then this case started to get really hostile a few months ago. Well, it was hostile before that, but really started to get hostile and now we have two sides that are taking very extreme positions. One saying that they can cram down a [section] 524(g) injunction on the debtor, and the debtor saying “We don’t have to use [section] 524(g) at all. We can just use the normal discharge to completely wipe out asbestos claims going forward.” Earlier this week, I believe, it was the court in that case did, in fact, in a very rare order, ordered that there be an asbestos claim bar date. Something that you almost never see in an asbestos case.

Even without this information we do see estimation procedures go forward. The estimation procedures are going to be used to try to, among other things, figure out what the aggregate asbestos liability is going to be not just for current claims, but for claims going into the future. That figure is going to be used primarily in negotiations. Trying to figure out what the dollar amount will be for funding the trust.

The major issue that I identify in the paper and I think that the third circuit picked up on last year was this idea of there not being any cram down at all for a [section] 524(g) injunction. You still have to satisfy all of your other obligations. You can still have a cram down for basic claims just like you would in any other chapter 11 case, but when you want to have a [section] 524(g) injunction you have to get 75% of the asbestos claimants’ vote in favor of it. There is no mechanism for cramming that down. There is no mechanism for overcoming this asbestos veto, as I’ve referred to it.

The claimants, and often in connection with the FCR [Future Claimants Representative] that they played a major role in appointing, often draw a line in the sand over certain issues that they want to preserve and they want to set a precedent not only in this case, but they want to set a precedent in future cases. Debtors or the insurers who may be opposing them on the other side equally don’t want that to happen, and so what we’ve seen in some cases is protracted litigation. Litigation that runs for several years. *PCC* is still in the system, as I noted in my statement. I even know that case was filed in 2000, April of 2000.

We see sides really dig in their heels, and we don’t see compromise. We don’t see real compromise until everyone reaches the point where basically there’s two prize fighters and both sides are about to fall apart. Then we start to see some real compromise. We see things sort themselves out, but that comes after a tremendous use and, frankly at times, waste of judicial and financial resources. This can happen even if the majority of claimants support various iterations of a plan that have been proposed by other parties. We saw that in the *Congoleum* case with a couple of proposed plan options that were opposed by certain very powerful members of the plaintiff’s bar, and those plans were subsequently withdrawn and not even considered.

As I noted in the paper, the trusts, once they are established tend to be overrun and that’s primarily because they tend to be designed to reflect the interests of current claimants. They may maximize contributions to the trust, but at times maximizing contributions to the trust have been negotiated out in order to provide that expeditious payment.

We see broad inclusive criteria for qualifying claims for payment. This goes beyond not just who had a right to payment under applicable tort law, and it may even go beyond those who had a reasonable expectation of payment in the tort system to claims that might have even been dismissed early in the case. At least if you believe what some lawyers have said, some plaintiff’s lawyers have said about their experience with submitting claims to trust.

I note in the paper that it does raise the floor for settlement as well, and there are avenues for increasing your own individual settlement amounts outside of the normal trust review process.

Finally, the projections have consistently been way off with respect to what the trusts are going to pay. This is different from what the estimate of what the liability would have been in the tort system. These are projections that are set up to try to figure out how much is the lifetime expense of this trust going to be, and then that is then used to figure out how much payments can be up front. Well if those projections underestimate claim volumes, then we see a lot of assets go out initially and then the trust doesn’t have enough money to continue paying claims at that level from that point on. Once that money goes out, they don’t get it back.

With the *Lumis* trust, which was set up and started operations a couple of years ago, they started out at a 100% payment. They paid every claim at the settled value, and before they could even finish that initial round of processing they had to drop their payment percentage to 10%. The *Than* trust realized during the course of that initial processing that they were receiving far more claims that they anticipated. They too, started at 100%. They dropped to 30% immediately after paying those claims that were submitted during that initial period.

This is not just a small issue for these litigants for plaintiffs who would have strong claims against them, and certainly for defendants in the tort system, who then pick up the slack. I will leave that with also noting that I raised some possibilities for addressing these issues. The idea of strengthening the independence of the FCR or taking a different approach or even combined approach of tying some of the FCR’s compensation to how well the trust actually does. I think that would be a little dangerous, but it’s at least an idea worth discussing. Of course the cramdown option, and I proposed tying that cramdown option to getting the support of the legal representative to balance out the issue and try to limit the possibility that a debtor would jump into bankruptcy and immediately try to cramdown perhaps tens or even more than 100,000 claimants to a plan and to a process that they don’t approve of. I think if we can structure it in a different way we can try to balance those interests a little better.

The mandatory hold back, and this was an idea that I borrow from the late Richard Nagareda in his book in 2007 “Mass Torts in a World of Settlement” where he argued for some sort of a mandatory hold back process. I, of course, modified it for bankruptcy, but I think it would work reasonably well at least in that primary objective of preserving assets for future victims.

Finally, I talk about transparency, but that’s more for trusts that have already been established and trying to figure out a way to deter some of the conduct that we’ve seen. I think that some of this kind of surreptitious front loading couldn’t occur if we had a more transparent system. With that I’ll step aside and be happy to answer your questions.

Keach: Thank you Professor Brown. I’m sure we’ll have a number. Professor Casey? Thanks.

Prof. Casey: Thank you for the opportunity to speak about priority today. I appreciate the earlier emphasis that we’re writing on a blank slate. Usually when I talk about these sorts of things, the first objection is, “Well, everything you’re about to say violates the Code.” I’m with you on that, so I like the blank slate. The question is with a blank slate, what should the priority rule in bankruptcy be?

I note in the written statement that priority might be a bit of a misnomer. It’s not really about the order in which creditors are paid, it’s, what is the claim that they’re entitled to when we’re paying out in that order? The absolute priority rule, as you know, says we’re going to pay senior creditors first. Again, the key is that the value that they’re going to get paid first is the value they would get in the liquidation, so we look at it as saying we’re going to pay senior creditors the liquidation value first, once they’re paid out as if this was a liquidation, we pay the junior creditors.

The problem that bankruptcy in chapter 11 is not a liquidation, so the idea that we have to shorten, collapse all the future value of the company to today’s value and then pay that out as if it was a liquidation is not required the way people think it is. What I mean by that is the defense of absolute priority is well, there’s this bargain outside of bankruptcy and you have senior creditors and you have junior creditors and we’d be violating the bargain if we pay them in a different order in bankruptcy, but when we don’t have a liquidation the company continues, and if we reorganize a company and it continues, the junior creditors stay as creditors. Their claims are alive if you reorganize it outside of bankruptcy. Think about it this way. If a company is worth 100 today as a going concern, the reason it is worth that is because it might be worth 50 or 150 tomorrow. The junior creditors get paid in the upside in the 150 world, and they don’t get paid, but they don’t lose anything more, in the downside of 50. The absolute priority says well we’re going to ignore those future things and just call it 100 and pay it out that way.

The question is, is this necessary to vindicate the creditors bargain? I think there are rights outside of bankruptcy that suggest a different outcome. Then the question is does it matter, right? When we look at the idea of what parties bargain for when they enter the contract we could say well these are all adults. These are all sophisticated parties. Whatever the rule is they’re going to price it into the original transaction, so in some sense, who cares? I think there’s a lot of truth to that.

The question I think is not as much, well what does the bargain require? What does some fundamental theory of the relationship require? It’s given they want a blank slate and that either priority rules, absolute priority or what I’ll talk about in a second is a relative priority that are possible because the parties will price it in, what’s going to get us the best outcome when we end up in bankruptcy?

When I talk about relative priority, the general thought is that we respect that value that the junior creditors have in the future possibility of the going concern. If we liquidate it we ignore that, but if the company’s kept alive we respect that. Well why does that matter? I think the best analogy and Professors Jackson and Scott were the first to bring this up. The best analogy is the maritime rule of general averages, right? If a ship is sinking and you start dropping off cargo, what you want to do is to make everyone bear the burden equally. When that happens everyone’s going to be trying to keep the ship afloat.

Well with the absolute priority, we do the exact opposite. We say well, whoever isn’t going to be in control is going to try to save their stuff, and you don’t have incentive to maximize the value of the ship or to keep it afloat. You just want to protect your stuff, right? Relative priority is the exact opposite from that. It says well, if the company survives and there’s an option value to the junior creditor we’ll keep that alive. They want to keep the company alive if that’s valuable. They want to sell it if they can get paid that option value. The senior creditor is in the same position. If we have absolute priority, they’re just worried about their first $100 of debt if, say, they have a lien of $100. If we have a relative priority, we have this proportion of it and you have this proportion of it, and so now we’re doing a rule of general averages. We want to keep the boat afloat and while working together.

If you look at what happens in bankruptcy, we see these incentives play out in the perverse nature that the rule of general averages analogy would suggest. When senior creditors gain control they often push for quick sales. Ed Morrison and Ken Ayotte have a nice paper called “Creditor Control and Creditor Conflict,” I think. He looks at this and says, “Well, when senior creditors get control we see quick sales. When junior creditors gain control through objections that are viable, we see drawn out reorganizations.” What’s going on is we have one party saying, “I want to sell it as quick as possible.” Another party saying, “I want to have it drag on so then my value might be materialized.” Neither of those groups are working for the value of the whole estate. They’re working for the value of their claim, so what happens is depending on who gains control, we know that we’re going to get an outcome that’s in their interest, but not efficient. In some cases we have early sales. In some cases we have drawn out reorganization, and we don’t know if we’re getting it in the right instance or not.

Given that problem with absolute priority, when we’re on a blank slate if we have a different priority, can we avoid that? The idea of keeping option value of the junior creditors’ future value in the going concern alive could do this, so in my written statement I suggest we could grant options, warrants to the junior creditors and say, “This is your claim on the future of the firm. It’s a warrant with a certain strike price.” Now when the senior wants to sell the firm in a [section] 363 sale they’re pushing the management to put a sale in place, they’re going to have to either buy that option out or sell the firm subject to that option. If they sell the firm subject to the option, the buyer is just going to discount for whatever that option was worth, right? Now they’ve internalized the value of the junior creditors’ future interest in the firm. They’re going to say, “Well, if the buyer is discounting it I can do better by paying off the junior creditor and getting rid of it. I’m going to do that.” The junior creditor has less incentive to object to a sale if either they’re being bought out, paid for their option or it’s being kept alive.

The problem of course is they might try to hold everything up and say, “Well I’m not going to sell my option.” Again, if the option is not worth much the buyer will discount the value of the option, but the junior creditor can’t do much other than say, “I’m not going to sell.” OK, don’t sell. “Don’t sell your option to me. I’ll sell this firm to a buyer subject to your option, which is so far out of the money.” That if that’s true, the buyer shouldn’t care. You have an option by the creditor’s own claim is never going to materialize, that’s really not burdening anybody. If it might materialize, you sell the firm subject to it and the junior creditors don’t have a hold up value they just simply say, “Well, I can either get paid for it or I can be stuck with it.” They should be indifferent between a true value payment and simply keeping the option.

In that world, you don’t have this ship sinking and everyone holding on to their own property. Instead, you have people working together and internalizing the cost. What I suggest in the paper is when we’re thinking about a priority rule we should step back from this assumption that absolute priority is sacred, as some have suggested, and require by the creditors bargain because it certainly isn’t. It might actually be counter to non-bankruptcy rights, and say what’s the most efficient outcome? Like I said, the best analogy is the rule of general averages.

There are other considerations as well, so when you have junior creditors and senior creditors conflicting with each other we have the cost of bargaining. We have the cost of hold up, so we say we want the junior creditors to be able to have the ability to sell a firm in a [section] 363 going concern sale, but we don’t want to have fire sales. What do we do? Well, we give some procedural protections to the junior creditors. That then creates hold up value, so they’re going to be … and we heard this in earlier panels. You give someone a right to insist on some sort of duty or some sort of procedure, what happens? Well, in the good cases they’ll insist upon it, and in the bad cases they’ll insist upon it to get value that they’re not entitled to. If instead we protect them substantively with the options, we can then reduce some of the procedural protections and the substantive protection doesn’t create the holdup, it simply creates the protection.

That’s the high level big picture of what I suggest in the paper is to rethink priority. To look at the cost of absolute priority, and look at how a scheme of relative priority might get better outcomes. Given that they’ll be priced into the ex ante lending, we shouldn’t worry too much about that. Given that we have this consideration, we think about the ex ante bargaining, we will tend to see that the creditors will, as I said, they’ll go into bankruptcy and they’ll have the same. The one other concern would be that the incentive to go into bankruptcy, and so if we have a distorted view outside where if it’s reorganized outside of bankruptcy then junior creditors stay alive, and if it’s reorganized in bankruptcy the junior creditors are wiped out, now we have different incentive among different classes of whether to file bankruptcy. Again, not based on the value to the firm, but based on particular interests. Again, this goes back to the sinking ship idea.

That’s the idea. There are a lot of details to be worked out, like the set of the strike price if we issue options. In an earlier paper, an academic paper, I talked about it being a perpetual option. I’ve backed off from that a little. I don’t think that’s necessarily the right way to think about it, but from a blank slate I think it’s definitely something worth considering.

Keach: Thank you. Mr. Levin, you had a question.

Levin: Yes. Thank you, Mr. Chairman. Professor Casey, I really like your idea. You know I’ve talked a little bit with Professor Barrett about the maritime law analogy and I think it’s very useful, but here’s the problem I have with what you just said. It’s kind of the same problem I had with Professor Bebchuk’s idea which you push aside a little bit in your paper, and that is, you talk about the junior creditors deciding to sell or to hold.

Prof. Casey: Yes.

Levin: I have two questions. Don’t you have to do that on a class basis? If you want junior creditors to pick one by one, how does it work? How do you do it on class basis? How much time does that take? What are the procedures and how do you allocate among your juniors? You know you got to go through the whole claims allowance process before you allocate among your juniors.

Prof. Casey: The claims allowance, I wouldn’t view that as any different than the current system.

Levin: No, it’s the same, but if you’re talking about seniors pressing for a quick sale or the juniors deciding whether they want to sell or hold, they can’t decide quickly if the claims allowance process is going to take two years.

Prof. Casey: I see what you’re saying.

Levin: But they don’t know how much they’re going to get. I mean how it’s going to be divided within the class.

Prof. Casey: Yes, that’s a good point. Given the frame of that, let me talk about the first point and then get to that. As far as the class issue, there’s two ways to think about it, putting aside this claims allowance question. The first one is you could have similar to a committee system where you have a vote among the class to accept an offer or not, so in an earlier academic piece that’s the way I suggested it. You have a “take it or leave it” offer from the senior to the class of juniors, and they, as a class, vote to accept the offer or not. If they don’t their options stay alive.

Another way to look at is to simply say we could do it on a one off basis and say, well you’re going to sell this firm, and you’re going to sell it subject to some options, and some of them you’re going to buy out and some of them you’re not. Ultimately, when you get the buyer to the table they’re going to know which options are still existing and not, so we see lots of companies operating outside of bankruptcy with call options on equity all over the place. I’ll also note that in bankruptcy settlements we see exactly this. We see warrants issued to a class of creditors.

I don’t know that there’d be any problem unless you’re really worried that having this group of partial options that just has to be bought out or the firm can’t survive, then we shouldn’t worry about doing it on a one off basis. In the paper I submitted here, I suggested you could have some sort of out procedure to say that if it really is extreme or crucial the senior creditor or the debtor trying to make the sale could say, “Wait, we need to get rid of these options.” I think that would be in an extreme case and we then shift the burden to prove it, which then the person pushing for the sale also is the one engaging the procedural mechanism.

Again, I’m kind of on the fence of whether you need to have a class system or class sale or not.

Levin: The question is whether buyers are going to go along with it if there’s a lot of small option holders out there.

Prof. Casey: If you think about it this way, if the senior creditors often say, “Wait, you’re so far out of the money. Why are we bothering with this?” Here the court is saying, “They need to put their money where their mouth is.” If they are so far out of the money, the buyer shouldn’t care, right?

Levin: Not sure that’s how buyers operate.

Seery: It depends on the duration as well. Volatility and duration are going to dictate the value of the option, and you can’t give a long dated option, the buyer’s not going to accept that because you’re going to take away the upside of the buyer’s investment.

Prof. Casey: Absolutely. That was why, I said in an earlier paper I talked about perpetual one and I backed off on that. I think you do have to set some sort of date down, and that’s what you see in these settlements that have warrants. You could think about when you have to bake in the return if the senior creditor’s taking over, so the strike price could be rising over time to bake in an actual rate of return on the investment for the creditor. At some point it’s going expire and it’s going to be so high. The buyer will care, but they’re only going to care if it really … to the extent there’s a likelihood of it coming, in the time period set, becoming more valuable than that. We’re looking at a variance question.

Levin: Every buyer has enough optimism to say, “I’m going to make this a very valuable company, and why should they get the option value from my effort of making it so valuable? Had it stayed in the pre-bankruptcy stage that management would have ultimately run it into the ground. They would have gotten nothing.”

Prof. Casey: You’re going to pay less. The buyer’s going to pay less for the option, right? If everyone really is sophisticated parties. You’re going to pay less.

Levin: You can go on for a long time, but let me ask the second question which I came back to. Right now you have big fights over valuation cases. I can see how where the strike value, not the strike price, but the strike value is pay the seniors off in full. That’s the strike value, but how do you value the options and determine duration and all of the other things that go into making that up? Isn’t that going to be a big delay, big litigation, just as we have now?

Prof. Casey: Yes, so if you put that on the core ten, I agree 100%. That was why when I first thought about a type of perpetual option, I don’t think that’s right, but I don’t think you should have a discretionary setting. I think you could actually have an arbitrary long period or statutory period and, again, people price this into the cost ex ante. It won’t be perfect. Better to have a set time period than to have the court litigating the time period. Once you do that you can rely on the market to set the price of the option. The only thing left for the court to do is this strike price plus a rate of return.

Levin: What I’m saying is you don’t normally have seniors and juniors. You have seniors, juniors, equity…

Keach: And lots of people in between.

Levin: Yeah, and lots of people. Let’s take one of the middle classes. You’re going to give option value to the people junior to them, so you need to kind of cabin the amount of option value that you’re going to give to the middle class.

Prof. Casey: Yes.

Levin: How do you go about valuing that? Isn’t that a difficult process?

Prof. Casey: I think you could think about it as being an option on an option. Simply to say I have a call at 100 and you have a call on my call at 150. I mean we see this in real life, and I think we could arrange this. As to the claims allowance point I think that some details need to be worked out. It’s a complicated question of whether you could do it quickly or whether you could have an estimate that gets done ex post, but that’s probably the biggest challenge.

Keach: Mr. Butler has a question and then I’ve got a question, actually, for Professor Brown. Go ahead.

Butler: I’ll stick with Professor Casey for a moment, and while we’ve got the comfort of the blank slate, I also don’t think we can ignore the system that we have. The system that we have right now, by the way, allows us to ignore the absolute priority rule when we want to, right? Plans can ignore the absolute priority rule. They do. People can vote to say I’ll do it differently.

Keach: In fact, it’s a default rule, right?

Butler: Yes, and so you’ve got a system where you have a plan process and you have a stacking of claims and you got the development of the last 20 years of an independent secondary claims market that has been in a sophisticated way kind of trading in all of that and understanding what all those things are, right? I mean however the market looks at those things. I wonder how that system adapts if you change the basic premise of how you’re going to stack the mechanics of the structure. I’m actually very sympathetic and frankly interested and respectful of your paper. I think it raises a lot of interesting things because many of us are frustrated in situations where you see volatility in business enterprise value, and so all the sudden our careers have been in cases where you have a very high return of creditors in one set of circumstances, the world changes and all the sudden life changes for people. The people who are smart enough to come in and invest at higher places grab that value and then make lots of money when they emerge. Sometimes hundreds of millions of dollars. I get that, but I’m trying to figure out how do you think, as you’ve thought through this, how do you think the system withstands the sort of kind of moving from the current structure to this relative structure that you’re proposing?

Prof. Casey: There’s obviously going to be growing pains in any rewriting of a law that would be this drastic. As for claims trading, I think claims trading is one of the developments in bankruptcy that would make this work better, so to the point earlier about how are we going to have classes vote? You could actually see this making an even stronger push for funds to come in and buy claims to take a class to say, “We now have this option that we can negotiate as one single party with the potential buyer.” I think that mechanism is a nice development that would make this possible in a way that it wouldn’t have been 30 years ago, but there will be growing pains. It’s hard to predict exactly. I think you’ll have to have some sort of grandfather [clause] where loans that already exist are treated differently because we had different expectations when we entered those loans. We had different payouts expected, and I don’t know exactly how you would play that out, but that would be one thing to think about because otherwise you’re changing the value of a loan the moment you change it, but that’s true of any amendment to a bankruptcy code. That’s a recommendation that the Commission would have to think about for every policy point.

The interesting thing about the settlement point is they do settle, cases do settle plans that have relative priority in them, but right now that settlement is based on either the variance in the judicial valuation or the holdup value. What I’m suggesting is it would be more principled and more in line with incentives to have that value based on the actual variance of the company and the volatility of the company going forward, which then aligns the incentives better. I think there the settlements will continue to look the way they do, but the numbers will be less tuned to judicial procedural holdup and judicial valuation variance and more attuned to what the actual bargain is.

Butler: Can I have my follow question on this?

Keach: Yes, go ahead because then I do want to do something off yours.

Butler: The follow up question I have is earlier in your remarks you talked about, you set up an analogy where you sort of said, “Maybe the question is who cares?” Because the imperfections of the current system are priced into the deals as they’re done now. People or sophisticated parties understand those imperfections and price them into the way the system works. If you believe that then I want to go to what Commission Brandt always asks which is, what’s the public policy reason for doing this? Can you articulate why? You’re sitting down in front. If you were testifying in front of a Congressional Committee saying “Do these things.” What are the five cogent public policy reasons that you would do this? What makes this the right thing to do?

Prof. Casey: This is why I think the maritime analogy really fits. If you had a rule of general averages on a sinking ship or you had a rule of take what you get on a sinking ship that would be priced into the ticket for the ship and the insurance. There’s no question about that, but what changes is whether the ship sinks or not, and I think that’s what’s going on here. Everyone’s going to price it and no one’s getting, no creditor is being treated unfairly under either rule. It’s simply that now when they enter bankruptcy with absolute priority rule they have the wrong incentives.

Keach: Isn’t the problem with that analogy that everybody on your ship has chosen to be there? We have whole creditor classes in real chapter 11 cases who are involuntary claimants. They haven’t priced anything. They haven’t assessed the market. They’re completely involuntary participants in this restructuring. Tort claimants, to some degree, employees, etc. What do you do about those people who don’t have the capacity to make the kind of choices on valuation you’re talking about?

Prof. Casey: I’ve been bracketing that a little, for one main reason is that in my understanding from empirical work that’s been done is they’re actually a smaller factor than people assumed. In the late 1990’s people were worried about the non-adjusting creditors. I believe there’s been empirical work to show that these cases, these middle market bankruptcies are really turning on equities out of the money. There’s really not that much tort liability going on. It’s really about general unsecured creditors who do price it in.

The other reason I bracket it is it’s a totally different problem. The non-adjusting creditor is something that proposes to deal with or give them super priority. All of that, I think there really are two different questions, in my mind. There’s what we do with people who go into this bargain knowingly? What’s the priority rule there? And what do we do with non-adjusting creditors, the prototype being the tort victim? You could have one rule that’s completely disconnected from the other rule, and my proposal’s really about the first group.

Keach: But it doesn’t answer the second group.

Prof. Casey: It doesn’t and so off the cuff I would think there’s something to said, if we think it’s a real problem, to the idea of super priority for tort victims, but there’s a lot of issues with that as well. If it’s a small problem it shouldn’t matter either way.

Keach: Except we’ve actually tried that, not just with tort victims, but from lots of other people. We’ve done the explosion of administrative claims thing and it doesn’t really work all that well, and you just get more chapter 11 cases you can’t confirm, but that’s a nice segue actually to my question to you, Professor Brown, which is I found the paper very interesting from the standpoint of current asbestos cases and I say this somewhat gingerly because my firms been involved in asbestos defense for I think about 40 or 50 years now or however long it’s been going, but someday those cases will end. I’m actually more interested in your work at the general proposition, and that is I’m in a case right now involving a mass accident in and environmental disaster where those kinds of issues will arise. The law is very uneven district to district, circuit to circuit on the use of channeling injunctions and trusts. I’m curious what are the lessons we can take from the experiment with the statutory asbestos trust that we could take to create a statutory mechanism that would work for all kinds of tort and personal injury and other environmental claims, etc.? What should we keep from that experiment that we’ve now had several years to try out? What should we throw out?

Prof. Brown: There are some basic concepts of [section] 524(g) that go back to the early asbestos cases that were ingenious. From a due process standpoint, the appointment of the legal representative, it was a nice way to bring that in, and we’ve seen that in not only bankruptcies but outside of asbestos, the *Corning* bankruptcy and so forth. You know, those cases. We’ve also seen it increasingly in some MDL type cases. We saw it in BP where they appointed a futures representative to come in at the settlement stage. That’s a good place to start, and what I think we have learned there is that if we want to have a future’s representative who is going to be above suspicion then there does need to be an independent process there. It does not need to be left to the litigants themselves, and that model is a great idea, but we can tweak the way that the appointment occurs.

As far as setting up trusts, I think, again, the points that I made here, and this goes to the lessons that we’ve learned from other mass settlements. You’ve got to be very careful about that inclination to trade off the future victim’s interest whenever you have an arrangement like that. It is not just limited to asbestos. It’s happened across the board. If you combined future claimants and give that defendant lasting peace then there is going to be some kind of a tradeoff there. Current claimants who realize that there’s value in giving that defendant lasting peace are going to extract some of that value for themselves, and so you need to have stronger mechanisms in place to protect against that.

As far as making it more generally applicable, I think that some of the things that are unique to asbestos, some of the issues now that we’re having 60 trusts out there, some of the administrative issues and the lack of communication there, that’s probably going to be unique to asbestos.

Butler: Why do you say that? Why do you think that the trust issues are unique to asbestos?

Prof. Brown: No, I mean, just to be clear I think when I’m talking about the administrative issues, I’m talking about the lack of communication from trust one to trust 59. The lack of communication from those trusts to other defendants who have remained in the tort system who are still being sued and the impact on them, where those same claimants have claims against the trust.

Keach: What you mean is that’s just a product of the just universality of the asbestos problem, right?

Prof. Brown: It is the massive, just seemingly limitless number of plaintiffs and arguably limitless number of potential defendants.

Keach: And not an issue, for example … I’ll pick an example like with the *IUD* cases, right? Because that was a finite set.

Prof. Brown: Exactly. When you have a finite group of defendants I think you can arrange it, and that actually segues into something that I haven’t discussed in my paper, but I think would be useful in a broader mass tort context, is the idea that allowing those co-defendants to have some level of joint administration so all of their claims can just be addressed by one universal trust, which would make a lot more sense from an efficiency standpoint and that kind of goes back to the original [idea].

Keach: Just to jump in and Mr. Togut has a question I want to get to, but when you’re talking about the other co-defendants in the asbestos context, you’re talking about other debtors, right?

Prof. Brown: Could be other debtors.

Keach: Would you also bring in non-debtor co-defendants in that context?

Prof. Brown: Well it already happens in some of these [section] 524(g) cases if those liabilities are derivative then those co-defendants definitely come in.

Keach: Well, to the extent they’re derivative. That’s the key consideration, right?

Prof. Brown: Right.

Keach: There still has to be a nexus to the underlying case.

Prof. Brown: There does, though at times that nexus doesn’t always appear as obvious as you might think.

Togut: I’d like to ask some questions, and forgive me I’m on the tail end of a cold. Just by way of disclosure too, I’m the future claims rep in *Quigley* which was the Pfizer subsidiary and I can tell you that not only wasn’t I picked by the boys, I was chosen because of my independence, but by the end of the case they didn’t like me very much.

Keach: You think about the plaintiff’s lives and you and I have a unity I think in that respect.

Togut: Professor Brown knows what I mean when I say the boys. I have a few questions about all this. First off, right now the bankruptcy court cannot adjudicate tort claims, right? I really like your idea of a bar date for asbestos claims. I think it would address the issue of a flood of claims coming in post confirmation. Are you suggesting that the bankruptcy court ought to be able to adjudicate tort claims?

Prof. Brown: I don’t think that’s necessary. I think that the district court could withdraw the reference on those specific claims and whether the district court wants to do that is another question, but they may not have a choice right now.

Togut: OK, what I’m asking is in a normal chapter 11 case you adjudicate claims, you adjust them but in an asbestos case you can’t do that using a court. Are you suggesting the court should allow itself to be used for that purpose?

Prof. Brown: I think that if we’re looking at the current code right now, I think that you could say that that court can look at those claims. Not for allowance purposes, but certainly for the purpose of estimating and deciding what votes are going to be in place.

Keach: Presumably for the creation of the size of the trust or at least the initial size of the trust, right?

Prof. Brown: One of the things that really stuck out to me in *Quigley* was the whole issue with Whites’ claims and some of the issues there with respect to, “Look, just pay me what I’m demanding and I walk away and you get confirmed.” Well he was demanding a figure that was so much higher than everyone else in the case, and I’m not saying that he was wrong to do that. I’m not criticizing Perry Whites in that regard. I think he’s a very good lawyer. He’s very hard charging for his clients. When I say that some people take it that I’m criticizing the lawyer, and just as an aside, my response to that is to refer to Chris Rock who said after the Siegfried and Roy thing where Roy was attacked by one of the tigers. He said, “You know all these people are saying these tigers went crazy. Those tigers didn’t go crazy. That tiger went tiger, and you put that tiger in a situation where that tiger can be a tiger and don’t be surprised when he’s a tiger.”

Togut: Right, and he was.

Prof. Brown: It’s the same situation here. Don’t be surprised when a lawyer who is that skillful, that intelligent, that creative and is willing to use everything that’s been given to him, uses it.

Togut: Wait, wait, wait. Just one more.

Keach: Sure, go ahead.

Togut: As you know, the plaintiff’s bar is concentrated in a few people, and they’re all involved in every one of these cases. I’m not really understanding your point about having a unified trust and being consistent case to case because the claimants, the plaintiffs, understand perfectly what’s going on in all these other cases, so could you expand on that?

Keach: You mean the plaintiff’s lawyers understand perfectly, not necessarily the plaintiffs.

Togut: Well, yes. The people in control though are the plaintiff’s bar.

Keach: Understood.

Prof. Brown: There are two arguments that we hear about audits, for example. We can’t have audits because if we had more extensive audits than we already have, the cost would be overwhelming, but many of the things that they could look at in those audits would be common across multiple trusts. I mean we’re talking 40 or so of the trusts have virtually identical provisions and virtually identical evidentiary requirements and so forth, so if you were to consolidate that and work on identifying claims where certain evidence doesn’t appear to match up with what you would see, you would have to do a top down audit. A stratified random audit with very strong data points to guide your analysis, but if you did that and you spread it across the trust suddenly the costs become a lot lower because they’re all sharing those costs and at the same time they’re getting a lot more data because they’re seeing how the claiming behavior is occurring across trusts.

That’s one area where I think that that could happen, and it doesn’t happen right now because with the exception of perhaps if you have multiple trusts being run by Veras or Delaware claims processing, one of those organizations that run multiple trusts. I still haven’t and nobody has ever told me that they actually do combined audits, and I’ve asked this question many times. It just doesn’t make sense that if you have that much data and you could use that data to really uncover where these specious practices are arising, that you’re not at least considering employing that type of an approach.

Keach: Thank you. Mr. Brandt, you had a question then I’ve got a last question, probably for Professor Casey.

Brandt: Professor Brown, you talked about expanding the [section] 524(g) analogy, if you will, to other tort claimants. I’ve had a couple of cases where I’ve actually had other solvents, and I was describing how it was going to solve a problem with a solvent company. No pun intended, and wonderfully discovered they had this small amount of asbestos exposure, which allowed me then to channel this into that structure. The point of my conversation on this is here we are, we’ve just finished a panel on new value and the rest of this. We’re fighting this issue, but [section] 524(g) offers shareholders a way to keep equity by giving up a portion of it going in, and I try and push a lot of people to look at the fact that it perhaps should be broadened beyond just asbestos to other tort claimants, but the model itself where you have a certainty of what you can keep if you’re willing to share the riches with one set of claimants is perhaps something we should all be looking at in a broader sense with respect to how to solve the new value problem and how to deal with it.

Prof. Brown: Right. Well when what was, I think, at one point referred to as proposed chapter 14, this would have been about 20 years ago, was put forward, that was somewhat the idea that we would have, we would take what had happened in *Manvil* and some of the other asbestos cases and we would try to learn from that and devise a statute and that’s one reason I think that the legislative history refers to [section] 524(g) as a statutory experiment that we would then learn from.

Then a few years later we see Francis McGovern publishes a very interesting, but short idea about [section] 524(g) without bankruptcy. Though he was saying just take it completely out of bankruptcy, I think that a lot of what he was saying there actually makes some sense that we can strip away some of the things that are unique to your typical historical bankruptcy. Some of the things that everyone has to go through and let’s have a very narrow system that is designed to address massed work claims, or other mass harm claims, and have it in a single forum. With the demise of the asbestos class actions and frankly, I think if you talk to most people who look at this today, just about any kind of a massed class action is going to have a lot of difficulty being run as a class action from beginning to end.

The model that we have after that is the MDL process, which is arguably not as strong as the class action process when it comes to protecting rights and balancing interest. Bankruptcy could be a really powerful system for consolidating claims and just carving up that piece of that debtor’s life. I don’t know if I answered your question or if I just danced around it.

Brandt: No, you did. The concept was your equity. You know that if you give away an acceptable sliver, not much of it, actually, you keep an acceptable sliver is the way I would look at it. You can get through this process, and as the members of the Commission and I sit here, we talk about this new value issue. Given the current state of the commercial lending markets, if you could get in sooner and give the creditors a quick number, not just tort limits and be assured that you would retain a sliver of equity, that may provide the model, as perverse as it may seem, all these years later for what we might want to do to reinvent chapter 11.

Keach: Professor Casey, I’ve got a question for you that actually builds on, I think, what Mr. Butler was asking you earlier about can the system essentially absorb this change. It goes to a sort of broader perspective on the same question, and this has come up time and time again in these hearings. If one looks at bankruptcy and chapter 11 in particular as, what I have referred to as, an involuntary system of shared sacrifice, the involuntary part being that the sacrifice is involuntary but which holds [the process] together. In other words, people accept being compelled to sacrifice because we have certain rules in place. Preferences were premised on the idea, or recovery of preferences was premised on the idea that you were sharing among the same class. The acceptance of that as legitimate cause of action erodes and has eroded because that underlying premise is no longer true.

If we take a similar idea with absolute priority, absolute priority is currently a necessary, but not sufficient condition of fair and equitable. It is in part in place historically because of the non-transparent deals that occurred in equity receiverships. It was a policing mechanism to guard against back door loss of value in secret deals arising out of equity receiverships, and then it grew from there. It is nonetheless presently seen by participants in the system as an element of fundamental fairness. If we allow this sort of market based approach to relative priority that you propose into the system, do we risk, frankly, losing the benefit of that perception of fundamental fairness, and does that cause the same strains that cause people to say, “I no longer want to play. I’m either going to exit myself legislatively or I’m just never going to commence the system.”

Prof. Casey: I think that goes to the question or to the point I made before I said, “Does it matter?” There was this idea of what are the non-bankruptcy rights? You’re right to say [that] one way to look at it is the world of equity receivership had some flaws to it, and this was a lot clearer, a lot more straight forward, a lot more bright line, and so people accepted that as fair. I think over time the idea that is fundamentally fair has morphed into, “Oh, and it’s the rights you have outside of the bankruptcy.”

Keach: But it’s also the rights inside. I mean the priorities are also inside of bankruptcy as well.

Prof. Casey: The reason that’s a fair rule is because it mimics the outside. My main contention is that that’s erroneous. Then the question is if we change to a rule that might more accurately mimic the non-bankruptcy rights, will it nonetheless be viewed as unfair because it’s just not as bright line? I think that risk is there, I just think though the difference I would say is that the world in 1920 and the world now is so much different.

Keach: In terms of availability of information, transparency, that sort of stuff?

Prof. Casey: Availability of information, transparency, really the sophistication of the various levels of parties. Remember, the interesting thing with equity receivership and the adoption of absolute priority was people were worried that you were using equity receivership to hurt the junior creditors, and really now the reverse is the argument generally, right? I think it’s just the finance world is so different. There’s always ways to kind of hide value and break the rules. I don’t know that I believe that today relative priority is going to allow that more than absolute priority.

Keach: It seems to me what we had was maximum flexibility, but not great transparency and information, right?

Prof. Casey: Yes.

Keach: We went away from that to a system that’s very rigid to guard against that. We, as you point out, constantly fight against that rigidity. We developed gift plans, so there’s something about the system that’s pushing back against the rigidity because it’s not working to reorganize companies in ways that get deals done. I guess the question is where along that progression we need to sit and whether relative priority all by itself needs to be supplemented by some of the issues we talked about that you haven’t covered that govern intervening classes and fairness.

Prof. Casey: One way to think about it, as you mentioned gifting and new value, is relative priority. I mean in some sense you could think of it as saying, “we see these settlements where we give DVH top priority and people complained. Other people said, “Well this is fine. This is just the way things are settled.” Just switch that to the default rule. Is there any reason why? Given that we’re doing it anyway, having it as a default rule is more likely to lead to kind of hidden transactions. I don’t see that that as obvious especially in a world where we don’t know what to do with new value and gifting.

Keach: I suppose the question is can it be a default rule failing agreement and failing something else? I guess then the question is how do we fill in that blank?

Seery: One quick question because I like the idea and we do use it, we do contract around and do contingent value rights all the time in cases that are really the option you talk about, and typically they have a fixed duration and they’re effectively callable by the senior creditor, whatever role he ends up assuming. A premise of this, the way you’ve structured it, Professor Casey, is that you value liquidation. Meaning a true liquidation, if you will, at the time that you’re striking this option or giving this option, and you don’t value the stuff or the interstices between the physical collateral that I have and the going concern, and one problem is that that will be a case by case determination, so very different if I have a lien on the property that a mall is on, for example, than an operating company because at the mall I’ve got everything. There’s no other thing, and perhaps if I only have the copy machine and the lights and the desks that’s not the same with the whole enterprise is a service business. Is that fair in terms of the underlying premise?

Prof. Casey: Yes, I think that’s absolutely fair, and some of the considerations that people have said when talking about absolute priority and equity receivership is absolute priority makes sense in a single asset real estate. That’s where the idea really mimics a real estate foreclosure because it’s not a going concern issue. Just one property, one asset. The equity receivership was for railroads, and I think that, as you stated, that the going concern value of one asset that’s a single asset that has no going concern is its liquidation value in some sense. Really, we’re talking about cases where there is some other value, and I think it’s case by case, but I think it actually would be fairly easy to identify the cases that are the distinction, I think.

Keach: We have this habit of going over. I apologize, but to get to one other point in your paper that I just wanted to focus on. One of the things you said in your paper was that essentially if you look at senior debt their only, this is my word not yours, legitimately non-bankruptcy expectation is the recovery of liquidation value because that would be the effect of the failure outside of the bankruptcy system. Would you carry that same concept over into concepts like adequate protection?

Prof. Casey: Yes. I think that’s absolutely right. What I would note is that I think it’s much easier to value a liquidation than a going concern value. I noted in there, in the paper, we want to keep the court procedures to a minimum, because that’s where the holdup comes in, in the threats to engage the court, but to the extent we have to have them value something. Liquidation value is going to be a lot more straight forward than going concern value, but absolutely the senior would be able to get adequate protection of their foreclosure value. I think that’s right.

Keach: All right. Thank you very much, we could do this all night, and I’m sure we would if they’d let us, but we should probably get out of here. Thank you very much. Your papers were great. The testimony was extremely helpful, and we appreciate it. Thanks.

Prof. Casey: Thank you.

Prof. Brown: Thank you.