On 8 December 2014, the American Bankruptcy Institute (“ABI”) Commission to Study the Reform of Chapter 11 (the “Commission”) issued a comprehensive report recommending changes to Chapter 11 of the US Bankruptcy Code (the “Report”), which governs business reorganizations. The Report is the culmination of a three-year effort by 22 leading insolvency professionals who served as commissioners and conducted 17 public field hearings around the US to gather testimony and examine significant issues with the current version of Chapter 11. The Commission’s study was guided by the following mission statement:

In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors – with the attendant preservation and expansion of jobs – and the maximization and realization of asset values for all creditors and stakeholders.3

The 400-page Report is ambitious, setting out approximately 240 recommendations for reform across 13 broad study topics. Those recommendations, in large part, flow from the Commission’s conclusion that the landscape of Chapter 11 proceedings has substantially changed since the enactment of the Bankruptcy Code in 1978. In particular, changes in the financing of companies and the nature of their assets, the advent of claims trading and derivative products, and the increasing globalization of business have introduced complexities that, according to the Commission, the current Bankruptcy Code was not designed to address. Of particular note, the Report observes that companies’ capital structures have become more complex and rely more heavily on secured financing, resulting in secured creditors having increasing control and influence over the Chapter 11 process. Indeed, one of the central themes of the Report, which has already generated a fair amount of controversy,4 is the rebalancing of the rights of secured creditors in Chapter 11 cases. While some of the Commission’s recommendations would benefit secured creditors, others would constrain the rights they enjoy under current law. As one example, the Report proposes the elimination of the practice of secured creditors providing a DIP loan for the purpose of paying down, in whole or part, their pre-petition claims (a so-called “roll-up” DIP).

The Commission’s proposals also aim to promote efficiencies and reduce litigation costs in Chapter 11 proceedings by resolving ambiguities in the statute and splits of authority among the U.S. Circuit Courts of Appeals (due to the infrequency of U.S. Supreme Court review, those are often the courts of last resort in bankruptcy cases).

Although a thorough review and assessment of the proposals is beyond the scope of this article, below is a discussion of three notable reforms that, if enacted into legislation, could materially affect the course of Chapter 11 proceedings.

Section 363 Sales
Under section 363 of the Bankruptcy Code, the trustee or debtor-in-possession can sell assets outside of the ordinary course of business after notice and a hearing. In addition, courts have developed standards for section 363 sales that generally require an auction and public sale process. It has become increasingly common for debtors to seek the sale of all or substantially all of their assets under section 363 (referred to as a “section 363x sale” in the Report) in the early stages of the Chapter 11 case. The Report proposes a moratorium on section 363x sales in the first 60 days of the case, unless it is demonstrated by clear and convincing evidence that there is a high likelihood that the value of the debtor’s assets will decrease significantly during such period.

Section 363 allows the purchaser, subject to certain conditions, to acquire the debtor’s assets free and clear of interests in those assets, and thereby section 363x sales offer a speedy and procedurally simple way to rehabilitate troubled businesses prior to the conclusion of the Chapter 11 case. While recognizing the benefits of section 363x

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1 Bob Dylan (1964).
2 The Report is available at http://commission.abi.org/ (last viewed 22 January 2015).
3 Report, p. 3.
4 The Loan Syndications and Trading Association (an organization that, among other things, advocates for the shared interests of loan market participants) has already issued a critical response to the Report, in which it contends that “some of the recommendations would undermine the Bankruptcy Code’s fundamental protections for secured creditors’ rights – protections that are central to the success of our bankruptcy system.” (Response available at http://lsta.org/news-and-resources/news/abi-commissions-report-on-bankruptcy-reform-and-the-lsta-s-response, last viewed 22 January 2015.)
sales, the Commission found that they are proceeding more quickly than necessary in many Chapter 11 proceedings, which can potentially reduce the value available for creditors. The Report also recommends that creditors be afforded “at least the same level of protection” in a section 363x sale process that they would receive in the plan confirmation process.

**Allocation of Value**

The absolute priority rule, codified in section 1129(b) of the Bankruptcy Code, provides that senior classes of creditors must be paid in full before junior creditors and equity holders receive any distribution under a Chapter 11 plan. Notwithstanding its bedrock status in US bankruptcy law (and the insolvency law of many other jurisdictions), the Commission has proposed a modification of the absolute priority rule. Specifically, the Report recommends that an immediately junior class of creditors that would not be entitled to any distributable value under the absolute priority rule should be entitled to an allocation of value referred to as the “redemption option value.”

Generally speaking, the redemption option value is the value of a hypothetical option to purchase the entire firm at an exercise price equal to the full face amount of the senior creditor class, with a duration equal to the time between the plan effective date or sale order and the third anniversary of the bankruptcy filing date. This proposal, arguably the most creative and controversial in the Report, seeks to counteract the inequities and frequent litigation associated with a debtor’s enterprise value being determined during a trough in the debtor’s business cycle or the economy as a whole, thereby resulting in a potential windfall to senior creditors (particularly where those creditors receive equity in the reorganized business).

**Estate Neutral**

The Bankruptcy Code currently provides for the appointment of an “examiner”, whose role is limited to conducting an investigation of the debtor, including an investigation of potential claims held by the estate. The Report proposes that the examiner role should be eliminated and replaced with the concept of an “estate neutral.”

The appointment of an estate neutral would not be mandatory; rather, the appointment would be made if the court determines that it serves the best interests of the estate. In contrast to the limited role of an examiner under current law, the court would have the flexibility to shape the role of the estate neutral according to the particular circumstances of the case. For example, that role could include serving as a mediator and facilitator in plan negotiations. The estate neutral may assist in the consensual resolution of Chapter 11 proceedings, particularly where plan negotiations are stalled or major litigation threatens to derail the reorganization efforts.

**Next on the Horizon**

While it is unclear whether — and if so, when — the U.S. Congress will propose legislation based on the Report’s recommendations, the Report will certainly generate a robust and spirited dialogue concerning the reform of Chapter 11. We should expect to hear much more in the coming months from special interest groups who will no doubt voice their views on the proposals. Insolvency professionals involved in Chapter 11 proceedings should also consider whether US bankruptcy judges will consult and seek guidance from the Report on issues that arise under the current statutory framework.